Internal Revenue
bulletin

Bulletin No. 1999–34
August 23, 1999

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 99–33, page 251.

Fringe benefits aircraft valuation formula. For purposes of section 1.61–21(g) of the Income Tax Regulations, relating to the rule for valuing noncommercial flights on employer-provided aircraft, the Standard Industry Fare Level (SIFL), cents-per-mile rates, and terminal charges in effect for the second half of 1999 are set forth.

Rev. Rul. 99–35, page 278.

Mutual life insurance companies; differential earnings rate. The differential earnings rate for 1998 and the recomputed differential earnings rate for 1997 are set forth for use by mutual life insurance companies to compute their income tax liabilities for 1998.

T.D. 8831, page 264.
REG–252487–96, page 303.

Final, temporary, and proposed regulations implementing sections 672(f) and 643(f) of the Code relate to the application of the grantor trust rules to certain trusts established by foreign persons. A public hearing is scheduled for November 2, 1999.

T.D. 8834, page 251.

Temporary regulations are removed and final regulations are added under section 367(e) of the Code relating to the treatment of distributions to foreign persons.

Rev. Proc. 99–32, page 296.

Procedures are provided for the repatriation of cash by a United States taxpayer via an interest-bearing account receivable or payable in an amount corresponding to the amount allocated under section 482 of the Code from, or to, a related person with respect to a controlled transaction. Rev. Procs. 65–17, 65–31, 70–23, 71–35, 72–22, 72–46, 72–48, 72–53, superseded. Rev. Rul. 82–80, superseded.

EMPLOYEE PLANS

Rev. Proc. 99–31, page 280.

This procedure sets forth acceptable correction methods and examples under the Employee Plans Compliance Resolution System that can be used to correct common problems in complying with the rules governing qualified plans. Rev. Proc. 98–22, clarified and supplemented.

Notice 99–39, page 313.

Weighted average interest rate update. The weighted average interest rate for August 1999 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

EXEMPT ORGANIZATIONS

Announcement 99–80, page 310.

A list is given of organizations now classified as private foundations.

ADMINISTRATIVE

Rev. Proc. 99–33, page 301.

Low-income housing tax credit. This procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under section 42(h)(3)(D) of the Code for calender year 1999.

REG–106527–98, page 304.

Proposed regulations under section 1223 of the Code relate to the sales or exchanges of interests in partnerships, S corporations, and trusts. A public hearing is scheduled for November 18, 1999.

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 61.—Gross Income Defined

26 CFR 1.61–21: Taxation of fringe benefits.

Fringe benefits aircraft valuation formula. For purposes of section 1.61–21(g) of the Income Tax Regulations, relating to the rule for valuing noncommercial flights on employer-provided aircraft, the Standard Industry Fare Level (SIFL), cents-per-mile rates, and terminal charges in effect for the second half of 1999 are set forth.

Rev. Rul. 99–33

For purposes of the taxation of fringe benefits under section 61 of the Internal Revenue Code, section 1.61–21(g) of the Income Tax Regulations provides a rule for valuing noncommercial flights on employer-provided aircraft. Section 1.61–21(g)(5) provides an aircraft valuation formula to determine the value of such flights. The value of a flight is determined under the base aircraft valuation formula (also known as the Standard Industry Fare Level formula or SIFL) by multiplying the SIFL cents-per-mile rates applicable for the periods during which the flight was taken by the appropriate aircraft multiple provided in section 1.61–21(g)(7) and then adding the applicable terminal charge. The SIFL cents-per-mile rates in the formula and the terminal charge are calculated by the Department of Transportation and are reviewed semi-annually.

The following chart sets forth the terminal charges and SIFL mileage rates:

Period During Which the Flight Is Taken	*Terminal Charge*	*SIFL Mileage Rates*
7/1/99-12/31/99	$32.41	Up to 500 miles = $.1773 per mile
		501–1500 miles = $.1352 per mile
		Over 1500 miles = $.1300 per mile

DRAFTING INFORMATION

The principle author of this revenue is Kathleen Edmondson of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information regarding this revenue ruling, contact Ms. Edmondson on (202) 622-6080 (not a toll-free call).

Section 367.—Foreign Corporations

26 CFR 1.367(e)–1: Distributions described in section 367(e)(1).

T.D. 8834

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Treatment of Distributions to Foreign Persons Under Sections 367(e)(1) and 367(e)(2)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document amends the Income Tax Regulations by removing temporary regulations on the treatment of distributions to foreign persons under section 367(e) of the Internal Revenue Code and adding final regulations under section 367(e). These final regulations are necessary to implement section 367(e)(1) and (2), as added to the Internal Revenue Code by the Tax Reform Act of 1986, which affects U.S. corporations.

DATES: These regulations are effective August 9, 1999.

FOR FURTHER INFORMATION CONTACT: Guy A. Bracuti, 202-622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in this final rule has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545–1487.

The collections of information in this regulation are in §§1.367(e)–1(d)(2), 1.367(e)–1(d)(3), 1.367(e)–2(b)(2), and 1.6038B–1(e). This information is required to obtain certain exemptions from taxation and to satisfy other information reporting requirements imposed by the Internal Revenue Code (Code). This information will be used by the **Internal Revenue Service** to verify whether a taxpayer is entitled to an exemption from income tax. The likely respondents are large corporations.

Comments on the collections of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by October 8, 1999.

Comments are specifically requested concerning: Whether the collections of information are necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility; The accuracy of the estimated burden associated with the collection of information (see below); How the quality, utility, and clarity of the information to be collected may be enhanced; How the burden of complying with the collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information. The estimated total annual reporting and/or recordkeeping burden is 2,471 hours. The estimated average annual burden hours per respondent and/or recordkeeper is 11 hours. The estimated number of respondents and/or recordkeepers is 217. The estimated annual frequency of responses is once.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 367(e)(1) amended the Code by providing regulatory authority to tax gain on a domestic distributing corporation's section 355 distribution of stock or securities to foreign persons. Section 367(e)(2) amended the Code by requiring a liquidating corporation to recognize gain (or loss) attributable to property distributed in a section 332 liquidation to a foreign parent corporation, except to the extent regulations provide otherwise.

On January 16, 1990, temporary regulations under section 367(e)(1) and (2) were published in the **Federal Register** (55 F.R. 1406 [T.D. 8280, 1990–1 C.B. 80]). A cross-referenced Notice of Proposed Rulemaking was published on that same date under RIN 1545–AL35 (55 F.R. 1472 [1990–1 C.B. 678]). The temporary regulations were proposed and issued to implement section 367(e) of the Internal Revenue Code of 1986 (Code), as amended by sections 631(d)(1) and 1810(g) of the Tax Reform Act of 1986 (100 Stat. 2085, 2272, Public Law 99–514 [1986-3 C.B.]). On January 25, 1993, final regulations under section 367(e)(1) were published in the **Federal Register** (58 F.R. 5927 [T.D. 8472, 1993-1 C.B. 51]). RIN 1545–AL35 was thereby closed. The preamble of T.D. 8472 stated that final regulations under section 367(e)(2) would be promulgated in a separate Treasury decision and that taxpayers could apply the provisions contained in §1.367(e)–2T to distributions occurring on or after January 16, 1993, and prior to the date that is 30 days after final regulations under section 367(e)(2) are published in the **Federal Register.** The final regulations under section 367(e)(1) were removed and replaced with temporary regulations that were published in the **Federal Register** on August 14, 1996 (61 F.R. 42165 [T.D. 8682, 1996–2 C.B. 12]). A cross-referenced Notice of Proposed Rulemaking was published on August 14, 1996 under RIN 1545–AU22 (61 F.R. 42217). A new RIN (RIN 1545-AX30) has been issued under which the section 367(e)(2) proposed regulations will be finalized.

No significant comments were received with respect to the 1996 Notice of Proposed Rulemaking with respect to section 367(e)(1). Comments were received with respect to the 1990 Notice of Proposed Rulemaking with respect to sections 367(e)(1) and 367(e)(2). No hearings were held on either Notice of Proposed Rulemaking.

Explanation of Revisions and Summary of Comments

I. *Overview*

These final regulations address the tax consequences of a distribution by a domestic corporation of its subsidiary's stock to foreign shareholders in a transaction described in section 355 (outbound section 355 distribution), a liquidation of a domestic corporation into a foreign parent corporation in a transaction described in section 332 (outbound liquidation), and a liquidation of a foreign corporation into a foreign parent corporation in a transaction described in section 332 (foreign-to-foreign liquidation).

Section 367(e) grants the Secretary authority to provide the extent to which a distributing corporation in an outbound section 355 distribution or liquidation or foreign-to-foreign liquidation may obtain the benefit of nonrecognition treatment when it makes the distribution to a foreign shareholder. The purpose of section 367 is to prevent the inappropriate avoidance of U.S. tax that can arise from the application of nonrecognition provisions in the cross-border context.

A. *Outbound section 355 distributions*

Section 367(e)(1) provides that a distribution under section 355 (or so much of section 356 as relates to section 355) by a U.S. corporation to its foreign shareholders is accorded nonrecognition treatment except to the extent provided in regulations. Section 1.367(e)–1 provides the circumstances under which such a distribution is taxable.

The legislative history to section 367(e)(1) provides that "transfers of stock by domestic corporations to foreign persons pursuant to Code section 355 . . . will give rise to the recognition of gain under Code section 367(e), to the extent provided in regulations. The committee expects that the Secretary will carefully consider the extent to which it is appropriate, in view of the purpose of section 367(e), to require the recognition of gain upon the transfer of the stock of a domestic corporation to foreign persons under section 355." H.R. Rep. 426, 99th Cong., 1st Sess. 931 (1985); S. Rep. 313, 99th Cong., 2nd Sess. 950 (1986).

The temporary regulations under section 367(e)(1) provide a general rule that a domestic distributing corporation is taxed on a distribution of controlled stock to foreign shareholders, regardless of whether the controlled corporation is a domestic corporation or a foreign corporation. Several exceptions are provided in the current temporary regulations in the case of an outbound distribution of stock of a domestic controlled corporation.

Consistent with the legislative history above and the temporary regulations, the final regulations continue to provide that an outbound section 355 distribution of a foreign controlled corporation is taxable to the distributing corporation. See also sections 367(b) and 1248(f) of the Code. In the case of an outbound section 355 distribution of a domestic controlled corporation, however, the final regulations amend the temporary regulations by providing that the distributing corporation shall obtain the benefit of nonrecognition treatment. In weighing the administrative burdens to taxpayers and the Government in connection with rules requiring gain recognition agreements and similar arrangements, the IRS and Treasury believe that adequate protections are in place to protect the policies of section

367(e)(1). Specifically, significant protections are provided in sections 355(d) and (e) and the device and continuity of interest requirements of section 355.

B. *Outbound and foreign-to-foreign liquidations*

Generally, a liquidating corporation does not recognize gain or loss on a distribution in complete liquidation into a parent corporation that meets the ownership requirements of section 332(b). See Section 337(a) of the Code. Section 367(e)(2) provides that a section 332 liquidation into a foreign parent is taxed to the liquidating corporation, except to the extent provided in regulations. Section 1.367(e)–2 provides the circumstances under which gain or loss on assets distributed in a section 332 liquidation into a foreign parent is not currently recognized.

Section 332 was enacted in 1935 to encourage the simplification of corporate structures and was retained in 1986 as an exception to the repeal of the General Utilities doctrine. Consistent with the policies of section 332, the final regulations generally tax the distribution of assets in an outbound liquidation but provide exceptions for assets over which the United States retains adequate taxing jurisdiction. The final regulations retain the exceptions in the proposed regulations for a distribution of assets used in the conduct of a U.S. trade or business and for a distribution of a U.S. real property interest (USRPI). In addition, the final regulations provide a new exception for a distribution of stock of a domestic subsidiary that is 80 percent owned by vote and value directly by the liquidating corporation.

In a foreign-to-foreign liquidation, the final regulations generally adopt the rules provided in the proposed regulations. Thus, the regulations generally provide that the liquidation is not taxable, except to the extent that assets used in a U.S. trade or business are distributed and not used in a U.S. trade or business over the subsequent ten-year period. The ten-year period (which is also used in the U.S. trade or business exception for outbound liquidations) supplements the principles contained in section 864(c)(7). The regulations also tax a distribution of assets that had formerly been used in the conduct of a U.S. trade or business by the liquidating corporation.

II. *Details of Provisions*

A. *Outbound section 355 distributions*

The final regulations amend the rule in the temporary regulations and do not require gain recognition on an outbound section 355 distribution of the stock or securities of a domestic corporation. The final regulations continue to require gain recognition on an outbound section 355 distribution of the stock or securities of a foreign corporation.

Where gain recognition is required, the final regulations amend the rules for determining the residency status of distributees of stock or securities in an outbound section 355 distribution. A distributee is presumed to be a person who is not a qualified U.S. person (i.e., a person that is not a U.S. citizen, resident, or corporation), except to the extent that the distributing corporation certifies that the distributee is a qualified U.S. person. A publicly traded distributing corporation may use a reasonable analysis with respect to distributees who are not five percent shareholders of publicly traded stock to demonstrate the number of distributees that are qualified U.S. persons. A reasonable analysis includes a determination of the actual number of distributees that are qualified U.S. persons or a reasonable statistical analysis of shareholder records and other relevant information. The final regulations also broaden the look-through rule in the temporary regulations for determining the identity of the distributees of stock or securities of a controlled corporation received by a partnership, trust or estate to include stock or securities received by a disregarded entity.

Section 1.367(e)–1 is applicable to distributions occurring in taxable years ending after August 8, 1999.

B. *Outbound and foreign-to-foreign liquidations*

1. *General Rule*

The final regulations under section 367(e)(2) contain two sets of rules, depending upon whether the liquidating corporation is domestic or foreign. The final regulations retain the rules of the proposed regulations with respect to foreign-to-foreign liquidations with only minor modification.

In the case of an outbound liquidation, a domestic liquidating corporation is generally required to recognize gain (or loss) on the distributed assets. In determining the amount of gain or loss recognized under the general rule, the proposed regulations contain an anti-netting rule and an anti-stuffing rule that limit the domestic liquidating corporation's ability to recognize losses.

Several commentators criticized the anti-netting rule contained in the proposed regulations as overly broad because the rule prohibits the netting of ordinary losses against capital gains. The final regulations take this into account and allow the netting of ordinary or capital losses against ordinary or capital gains to the same extent allowed under general rules of the Code, including section 1211.

Commentators also questioned the propriety of the anti-stuffing rule in the proposed regulations and argued that the anti-stuffing rules contained in section 336(d) and the loss limitation rules of section 382 should sufficiently address loss trafficking concerns. The anti-stuffing rule contained in the proposed regulations disallows the recognition of losses attributable to property acquired in capital contributions, section 332 liquidations, and exchanges under sections 351 and 361 within five years of the distribution.

The IRS and Treasury do not believe that sections 336(d) and 382 alone adequately address the Government's loss trafficking concerns. For example, neither section 336(d) nor 382 would limit a liquidating corporation's ability to recognize a loss that is acquired in a reorganization among affiliates even though the loss could not have been recognized if those corporations were liquidated individually. The anti-stuffing rule in the proposed regulations also does not adequately protect against the use of losses to offset gains where the loss corporation acquires the gain property.

After considering the issue, the Treasury and the IRS have amended the anti-stuffing rule in the final regulations to limit the recognition of built-in gains and losses attributable to property received by the domestic liquidating corporation in a reorganization or liquidation occurring within two years prior to the distribution. Sections 336(d) and 382 also limit loss recognition in applicable circumstances.

Comments also requested clarification on the treatment of a distribution of an interest in a publicly traded partnership (PTP). The final regulations provide that an interest in a PTP that is treated as a corporation under section 7704(a) shall be treated in the same manner as stock.

The final regulations retain the look-through rule for a domestic liquidating corporation's distribution of a partnership interest to its foreign parent. The look-through rule provides that, for purposes of the regulation, a domestic liquidating corporation is treated as distributing its proportionate share of the partnership property. The Treasury and the IRS hereby request comments on the proper method of calculating such gain or loss and reserve a section in the final regulations with respect to this issue. Comments should consider the application of similar rules in other cross-border contexts, such as Treas. Reg. §1.367(a)–1T(c)(3).

2. Exceptions to General Rule

The proposed regulations contain exceptions to the general gain recognition rule for the distribution of property used in a U.S. trade or business and the distribution of a USRPI. The final regulations retain the two exceptions with some modifications and add an additional exception for stock of a domestic subsidiary corporation.

Under the proposed regulations, a domestic liquidating corporation does not recognize gain (or loss) on the distribution of property used in a U.S. trade or business, if: (1) the foreign parent is not a controlled foreign corporation; (2) the foreign parent continues to use the property in a U.S. trade or business for a ten-year period following the distribution of such property; and (3) the domestic liquidating corporation and the foreign parent attach a statement to their U.S. income tax returns for the year of distribution. If within the ten-year period following a distribution, the property ceases to be used in the foreign parent's U.S. trade or business other than by a disposition, then the foreign parent is required to file an amended U.S. income tax return on behalf of the domestic liquidating corporation and recognize gain thereon. If the foreign parent disposes of such property, then the foreign parent recognizes gain (or loss) on its U.S. income tax return for the year of disposition in lieu of the domestic liquidating corporation recognizing gain on an amended return for the year of distribution. Also, under the proposed regulations, gain recognition is not triggered on involuntary conversions of such property under section 1033, like-kind exchanges of such property under section 1031, and the abandonment of obsolete or worthless property.

The final regulations modify the U.S. trade or business property exception in response to comments in several respects. First, the final regulations make the exception available to a domestic liquidating corporation that liquidates into a controlled foreign corporation. Second, the final regulations no longer require that the foreign parent file an amended return on behalf of the liquidating corporation when property ceases to be used in the conduct of a U.S. trade or business (whether by disposition or otherwise), provided that the foreign parent properly recognizes gain (or loss in the case of a disposition) as if the property had been sold for fair market value at the time the property ceases to be used in the conduct of a U.S. trade or business. Third, the final regulations expand the types of dispositions that will not trigger gain recognition. U.S. trade or business property may be transferred to another person without gain recognition, if the transfer is a disposition normally entitled to nonrecognition under the Code and the transferor and transferee satisfy various procedural requirements.

The final regulations retain the exception for a distribution of a USRPI contained in the proposed regulation with only minor modification.

The final regulations add a new exception that allows for nonrecognition of gain on a distribution of stock of a domestic subsidiary that is 80 percent owned (by vote and value) directly by the domestic liquidating corporation, provided that the liquidation does not have as a principal purpose the avoidance of U.S. tax on a subsequent disposition of the domestic subsidiary.

3. General Anti-abuse Rule

The final regulations contain a new anti-abuse rule that allows the Commissioner to require the liquidating corporation to recognize gain (or treat the liquidating corporation as if it had recognized loss) on the distribution of property pursuant to the liquidation if a principal purpose of the liquidation is the avoidance of U.S. tax. The rule would apply, for example, if a principal purpose of a liquidation is the distribution of a domestic liquidating corporation's earnings and profits without a U.S. withholding tax. In certain circumstances, the Service is also concerned about a liquidation of a domestic corporation into a U.S. branch of a foreign corporation in a manner that facilitates the avoidance of U.S. tax, including the inappropriate use of attributes such as net operating losses. Liquidations used to facilitate the avoidance of tax may be challenged under existing law. The Treasury and the IRS hereby solicit comments, however, as to other measures that should be taken to adequately address such transactions, including the more specific identification of the conditions under which liquidated property, particularly securities and other financial instruments, may be considered to be used in a U.S. trade or business.

4. Effective Date

Section 1.367(e)–2 is applicable to distributions occurring 30 days after August 9, 1999 or, if a taxpayer elects, to distributions in taxable years ending after August 8, 1999. In addition, taxpayers may rely on the principles contained in the temporary regulations issued under section 367(e)(2) on January 16, 1990 for distributions occurring prior to 30 days after August 9, 1999.

C. *Section 6038B*

The regulations under section 6038B are also revised to require reporting for transactions described in section 367(e)(1) and (2) in accordance with the final regulations under section 367(e)(1) and (2).

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collections of information contained in this regulation will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the number of section 367(e) distributions that require reporting under these regulations is estimated to be only 400 per year. Moreover, because these regulations will primarily affect large multinational corporations, it is estimated that out of the 400 transactions very few, if any, will involve small entities. Thus, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact of the proposed regulations on small business.

Drafting Information

The principal author of these regulations is Guy A. Bracuti of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for 1.367(e)–1T and by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.367(e)–1 also issued under 26 U.S.C. 367(e)(1).

Section 1.367(e)–2 also issued under 26 U.S.C. 367(e)(2). * * *

§1.367(e)–0T through §1.367(e)–2T [Removed]

Par. 2. Sections 1.367(e)–0T, 1.367(e)–1T, and 1.367(e)–2T are removed.

Par. 3. Sections 1.367(e)–0, 1.367(e)–1, and 1.367(e)–2 are added to read as follows:

§1.367(e)–0 Outline of §§1.367(e)–1 and 1.367(e)–2.

This section lists captioned paragraphs contained in §§1.367(e)–1 and 1.367(e)–2 as follows:

§1.367(e)–1 Distributions described in section 367(e)(1).

(a) Purpose and scope.
(b) Gain recognition.
(1) General rule.
(2) Stock owned through partnerships, disregarded entities, trusts, and estates.
(3) Gain computation.
(4) Treatment of distributee.
(c) Nonrecognition of gain.
(d) Determining whether distributees are qualified U.S. persons.
(1) General rule—presumption of foreign status.
(2) Non-publicly traded distributing corporations.
(3) Publicly traded distributing corporations.
(i) Five percent shareholders.
(ii) Other distributees.
(4) Qualified exchange or other market.
(e) Reporting under section 6038B.
(f) Effective date.

§1.367(e)–2 Distributions described in section 367(e)(2).

(a) Purpose and scope.
(1) In general.
(2) Nonapplicability of section 367(a).
(b) Distribution by a domestic corporation.
(1) General rule.
(i) Recognition of gain and loss.
(ii) Operating rules.
(A) General rule.
(B) Overall loss limitation.
(*1*) Overall loss limitation rule.
(*2*) Example.
(C) Special rules for built-in gains and losses attributable to property received in liquidations and reorganizations.
(iii) Distribution of partnership interest.
(A) General rule.
(B) Gain or loss calculation. [Reserved]
(C) Basis adjustments.
(D) Publicly traded partnerships.
(2) Exceptions.
(i) Distribution of property used in a U.S. trade or business.
(A) Conditions for nonrecognition.
(B) Qualifying property.
(C) Required statement.
(*1*) Declaration and certification.
(*2*) Property description.
(*3*) Distributee identification.
(*4*) Treaty benefits waiver.
(*5*) Statute of limitations extension.
(D) Failure to file statement.
(E) Operating rules.
(*1*) Gain or loss recognition by the foreign distributee corporation.
(*i*) Taxable dispositions.
(*ii*) Other triggering events.
(*2*) Gain recognition by the domestic liquidating corporation.
(*i*) General rule.
(*ii*) Amended return.
(*iii*) Interest.
(*iv*) Joint and several liability.
(*3*) Schedule for property no longer used in a U.S. trade or business.
(*4*) Nontriggering events.
(*i*) Conversions, certain exchanges, and abandonment.
(*ii*) Amendment to Master Property Description
(*5*) Nontriggering transfers to qualified transferees.
(ii) Distribution of certain U.S. real property interests.
(iii) Distribution of stock of domestic subsidiary corporations.
(A) Conditions for nonrecognition.
(B) Exceptions when the liquidating corporation is a U.S. real property holding corporation.
(C) Anti-abuse rule.
(D) Required statement.
(3) Other consequences.
(i) Distributee basis in property.
(ii) Reporting under section 6038B.
(iii) Other rules.
(c) Distribution by a foreign corporation.
(1) General rule—gain and loss not recognized.
(2) Exceptions.
(i) Property used in a U.S. trade or business.
(A) General rule.
(B) Ten-year active U.S. business exception.
(C) Required statement.
(D) Operating rules.
(ii) Property formerly used in a U.S. trade or business.
(3) Other consequences.
(i) Distributee basis in property.
(ii) Other rules.
(d) Anti-abuse rule.
(e) Effective date.

§1.367(e)–1 Distributions described in section 367(e)(1).

(a) *Purpose and scope.* This section provides rules for recognition (and nonrecognition) of gain by a domestic corporation (distributing corporation) on a distribution of stock or securities of a corporation (controlled corporation) to foreign persons that is described in section 355. Paragraph (b) of this section contains the general rule that gain is recognized on the distribution to the extent stock or securities of controlled are distributed to foreign persons. Paragraph (c) of this section provides an exception to the gain recognition rule for distributions of stock or securities of a domestic corporation. Paragraph (d) of this section contains rules for determining whether distributees of stock or securities in a section 355 distribution are qualified U.S. persons. Paragraph (e) of this section cross-references section 6038B for certain reporting obligations. Finally, paragraph (f) of this section specifies the effective date of this section.

(b) *Gain recognition*—(1) *General rule.* If a domestic corporation makes a distribution of stock or securities of a corporation that qualifies for nonrecognition under section 355 to a person who is not a qualified U.S. person, then, except as provided in paragraph (c) of this section, the distributing corporation shall recognize gain (but not loss) on the distribution under section 367(e)(1). A distributing corporation shall not recognize gain under this section with respect to a section 355 distribution to a qualified U.S. person. For purposes of this section, a qualified U.S. person is—

(A) A citizen or resident of the United States; or

(B) A domestic corporation.

(2) *Stock owned through partnerships, disregarded entities, trusts, and estates.* For purposes of this section, distributing corporation stock or securities owned by or for a partnership (whether foreign or domestic) are owned proportionately by its partners. A partner's proportionate share of the stock or securities of the distributing corporation shall be equal to the partner's distributive share of the gain that would have been recognized had the partnership sold the stock or securities (at a taxable gain) immediately before the distribution. The partner's distributive share of gain shall be determined under the rules and principles of sections 701 through 761 and the regulations thereunder. For purposes of this section, stock or securities owned by or for an entity that is disregarded as an entity (disregarded entity) under §1.7701–3(b)(1)(ii) or (b)(2)(i)(C) are owned directly by the owner of such disregarded entity. For purposes of this section, stock or securities owned by or for a trust or estate (whether foreign or domestic) are owned proportionately by the persons who would be treated as owning such stock or securities under section 318(a)(2)(A) and (B). In applying section 318(a)(2)(B)(i), if a trust includes interests that are not actuarially ascertainable, all such interests shall be considered to be owned by foreign persons. In a case where an interest holder in a partnership, a disregarded entity, trust, or estate that (directly or indirectly) owns stock of the distributing corporation is itself a partnership, disregarded entity, trust, or estate, the rules of this paragraph (b)(2) apply to such interest holder.

(3) *Gain computation.* Gain recognized under paragraph (b)(1) of this section shall be equal to the excess of the fair market value of the stock or securities distributed to persons who are not qualified U.S. persons (determined as of the time of the distribution) over the distributing corporation's adjusted basis in the stock or securities distributed to such distributees. For purposes of the preceding sentence, the distributing corporation's adjusted basis in each unit of each class of stock or securities distributed to a distributee shall be equal to the distributing corporation's total adjusted basis in all of the units of the respective class of stock or securities owned immediately before the distribution, divided by the total number of units of the class of stock or securities owned immediately before the distribution.

(4) *Treatment of distributee.* If the distribution otherwise qualifies for nonrecognition under section 355, each distributee shall be considered to have received stock or securities in a distribution qualifying for nonrecognition under section 355, even though the distributing corporation may recognize gain on the distribution under this section. Thus, the distributee shall not be considered to have received a distribution described in section 301 or a distribution in an exchange described in section 302(b) upon the receipt of the stock or securities of the controlled corporation, and the domestic distributing corporation shall have no withholding responsibilities under section 1441. Except where section 897(e)(1) and the regulations thereunder cause gain to be recognized by the distributee, the basis of the distributed domestic or foreign corporation stock in the hands of the foreign distributee shall be the basis of the distributed stock determined under section 358 without any increase for any gain recognized by the domestic corporation on the distribution.

(c) *Nonrecognition of gain.* A domestic distributing corporation shall not recognize gain under paragraph (b)(1) of this section on the distribution of stock or securities of a domestic corporation.

(d) *Determining whether distributees are qualified U.S. persons*—(1) *General rule—presumption of foreign status.* Except as provided in paragraphs (d)(2) and (3) of this section, all distributions of stock or securities in a distribution described in paragraph (b)(1) of this section are presumed to be to persons who are not qualified U.S. persons, as defined in paragraph (b)(1) of this section.

(2) *Non-publicly traded distributing corporations.* If the class of stock or securities of the distributing corporation (in respect to which stock or securities of the controlled corporation are distributed) is not regularly traded on a qualified exchange or other market (as defined in paragraph (d)(4) of this section), then the distributing corporation may only rebut the presumption contained in paragraph (d)(1) of this section by identifying the qualified U.S. persons to which controlled corporation stock or securities were distributed and by certifying the amount of stock or securities that were distributed to the qualified U.S. persons.

(3) *Publicly traded distributing corporations.* If the class of stock or securities of the distributing corporation (in respect to which stock or securities of the controlled corporation are distributed) is regularly traded on a qualified exchange or other market (as defined in paragraph (d)(4) of this section), then the distributing corporation may only rebut the presumption contained in paragraph (d)(1) of this section as described in this paragraph (d)(3).

(i) *Five percent shareholders.* A publicly traded distributing corporation may only rebut the presumption contained in paragraph (d)(1) of this section with respect to distributees that are five percent shareholders of the class of stock or securities of the distributing corporation (in respect to which stock or securities of the controlled corporation are distributed) by identifying the qualified U.S. persons to which controlled corporation stock or securities were distributed and by certifying the amount of stock or securities that were distributed to the qualified U.S. persons. A five percent shareholder is a distributee who is required under U.S. securities laws to file with the Securities and Exchange Commission (SEC) a Schedule 13D or 13G under 17 CFR 240.13d–1 or 17 CFR 240.13d–2, and provide a copy of same to the distributing corporation under 17 CFR 240.13d–7.

(ii) *Other distributees.* A distributing corporation that has made a distribution described in paragraph (d)(3) of this section may rebut the presumption contained in paragraph (d)(1) of this section with respect to distributees that are not five percent shareholders (as defined in this paragraph (d)(3)) by relying on and providing a reasonable analysis of shareholder records and other relevant information that demonstrates a number of distributees that are qualified U.S. persons. Taxpayers may rely on such analysis, unless it is subsequently determined that there are actually fewer distributees who are qualified U.S. persons than were demonstrated in the analysis.

(4) *Qualified exchange or other market.* For purposes of paragraph (d) of this section, the term qualified exchange or other market means, for any taxable year—

(i) A national securities exchange which is registered with the SEC or the national market system established pursuant to section 11A of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(ii) A foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located and which has the following characteristics—

(A) The exchange has trading volume, listing, financial disclosure, and other requirements designed to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors; and the laws of the country in which the exchange is located and the rules of the exchange ensure that such requirements are actually enforced; and

(B) The rules of the exchange ensure active trading of listed stocks.

(e) *Reporting under section 6038B.* See the regulations under section 6038B for reporting requirements for distributions under this section.

(f) *Effective date.* This section shall be applicable to distributions occurring in taxable years ending after August 8, 1999.

§1.367(e)–2 Distributions described in section 367(e)(2).

(a) *Purpose and scope*—(1) *In general.* This section provides rules requiring gain and loss recognition by a corporation on its distribution of property to a foreign corporation in a complete liquidation described in section 332. Paragraph (b)(1) of this section contains the general rule that gain and loss are recognized when a domestic corporation makes a distribution of property in complete liquidation under section 332 to a foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in the domestic corporation. Paragraph (b)(2) of this section provides the only exceptions to the gain and loss recognition rule of paragraph (b)(1) of this section. Paragraph (b)(3) of this section refers to other consequences of distributions described in paragraphs (b)(1) and (2) of this section. Paragraph (c)(1) of this section contains the general rule that gain and loss are not recognized when a foreign corporation makes a distribution of property in complete liquidation under section 332 to a foreign corporation that meets the stock ownership requirements of section 332(b) with respect to stock in the foreign liquidating corporation. Paragraph (c)(2) of this section provides the only exceptions to the nonrecognition rule of paragraph (c)(1) of this section. Paragraph (c)(3) of this section refers to other consequences of distributions described in paragraphs (c)(1) and (2) of this section. Paragraph (d) of this section contains an anti-abuse rule. Finally, paragraph (e) of this section specifies the effective date for the rules of this section. The rules of this section are issued pursuant to the authority conferred by section 367(e)(2).

(2) *Nonapplicability of section 367(a).* Section 367(a) shall not apply to a complete liquidation described in section 332 by a domestic liquidating corporation into a foreign corporation that meets the stock ownership requirements of section 332(b).

(b) *Distribution by a domestic corporation*—(1) *General rule*—(i) *Recognition of gain and loss.* If a domestic corporation (domestic liquidating) makes a distribution of property in complete liquidation under section 332 to a foreign corporation (foreign distributee) that meets the stock ownership requirements of section 332(b) with respect to stock in the domestic liquidating corporation, then–

(A) Pursuant to section 367(e)(2), section 337(a) and (b)(1) shall not apply; and

(B) The domestic liquidating corporation shall recognize gain or loss on the distribution of property to the foreign distributee, except as provided in paragraph (b)(2) of this section.

(ii) *Operating rules*—(A) *General rule.* Except as provided in paragraphs (b)(1)-(ii)(B) and (C) of this section, the rules contained in section 336 will apply to the gain and loss recognized pursuant to this section.

(B) *Overall loss limitation*—(*1*) *Overall loss limitation rule.* Loss in excess of gain from the distribution shall not be recognized. If realized losses exceed recognized losses, the losses shall be recognized on a pro rata basis with respect to the realized loss attributable to each distributed loss asset in the category of assets (i.e., capital or ordinary) to which the realized but unrecognized loss relates. For additional limitations on the recognition of losses, see, e.g., section 1211.

(*2*) *Example.* The following example illustrates the overall loss limitation rule, the pro rata loss allocation method, and the general capital loss limitation rule in section 1211(a):

Example. F, a foreign corporation, owns all stock of US1, a domestic corporation. US1 owns the following capital assets: Asset A, which has a fair market value of $100 and an adjusted basis of $40; Asset B, which has a fair market value of $60 and an adjusted basis of $80; and, Asset C, which has a fair market value of $40 and an adjusted basis of $100. US1 also owns the following business assets that will generate ordinary income (or loss) upon disposition: Asset D, which has a fair market value of $100 and an adjusted basis of $40; Asset E, which has a fair market value of $60 and an adjusted basis of $100; and, Asset F, which has a fair market value of $40 and an adjusted basis of $80. US1 liquidates into F and distributes all assets to F in liquidation. None of the assets qualify for nonrecognition under paragraph (b)(2) of this section. US1's total realized capital loss is $80, but it may only recognize $60 of that loss. See section 1211(a). US1's total realized ordinary loss is $80, but it may only recognize $60 of that loss. See paragraph (b)(1)(ii)(B)(*1*) of this section. US1 will allocate $45 (60 × .75) of the recognized capital loss to Asset B and will allocate the remaining $15 (60 × .25) of recognized capital loss to Asset C. See paragraph (b)(1)(ii)(B)(*1*) of this section. US1 will allocate $30 (60 × .50) of the recognized ordinary loss to Asset E and will allocate the remaining $30 (60 × .50) to Asset F. See paragraph (b)(1)(ii)(B)(*1*) of this section.

(C) *Special rules for built-in gains and losses attributable to property received in liquidations and reorganizations.* Built-in losses attributable to property received in a transaction described in sections 332 or 361 (during the two-year period ending on the date of the distribution in liquidation covered by this section) shall not offset gain from property not received in the same transaction. Built-in gains attributable to property received in a transaction described in sections 332 or 361 (during the two-year period ending on the date of the distribution in liquidation covered by this section) shall not offset loss from property not received in the same transaction. Built-in gain or loss is that amount of gain or loss on property that existed at the time the domestic liquidating corporation acquired such property. See sections 336(d) and 382 for additional limitations on the recognition of losses.

(iii) *Distribution of partnership interest*—(A) *General rule.* If a domestic corporation distributes a partnership interest (whether foreign or domestic) in a distribution described in paragraph (b)(1)(i) of this section, then for purposes of applying this section the domestic liquidating corporation shall be treated as having distributed a proportionate share of partnership property. Accordingly, the applicability of the recognition rules of paragraphs (b)(1)(i) and (ii) of this section, and of any exception to recognition provided in this section shall be determined with reference to the partnership property, rather than to the partnership interest itself. Where the partnership property includes an interest in a lower-tier partnership, the applicability of any exception with respect to the interest in the lower-tier partnership shall be determined with reference to the lower-tier partnership property. In the case of multiple tiers of partnerships, the applicability of an exception shall be determined with reference to the property of each partnership, applying the rule contained in the preceding sentence. A domestic liquidating corporation's proportionate share of partnership property shall be determined under the rules and principles of sections 701 through 761 and the regulations thereunder.

(B) *Gain or loss calculation.* [Reserved]

(C) *Basis adjustments.* The foreign distributee corporation's basis in the distributed partnership interest shall be equal to the domestic liquidating corporation's basis in such partnership interest immediately prior to the distribution, increased by the amount of gain and reduced by the amount of loss recognized by the domestic liquidating corporation on the distribution of the partnership interest. Solely for purposes of sections 743 and 754, the foreign distributee corporation shall be treated as having purchased the partnership interest for an amount equal to the foreign corporation's adjusted basis therein.

(D) *Publicly traded partnerships.* The distribution by a domestic liquidating corporation of an interest in a publicly traded partnership that is treated as a corporation for U.S. income tax purposes under section 7704(a) shall not be subject to the rules of paragraphs (b)(1)(iii)(A) and (B) of this section. Instead, the distribution of such an interest shall be treated in the same manner as a distribution of stock. Thus, a transfer of an interest in a publicly traded partnership that is treated as a U.S. corporation for U.S. income tax purposes shall be treated in the same manner as stock in a domestic corporation, and a transfer of an interest in a publicly traded partnership that is treated as a foreign corporation for U.S. income tax purposes shall be treated in the same manner as stock in a foreign corporation.

(2) *Exceptions*—(i) *Distribution of property used in a U.S. trade or business*—(A) *Conditions for nonrecognition.* A domestic liquidating corporation shall not recognize gain or loss under paragraph (b)(1) of this section on its distribution of property (including inventory) used by the domestic liquidating corporation in the conduct of a trade or business within United States, if—

(*1*) The foreign distributee corporation, immediately thereafter and for the ten-year period beginning on the date of the distribution of such property, uses the property in the conduct of a trade or business within the United States;

(*2*) The domestic liquidating corporation attaches the statement described in paragraph (b)(2)(i)(C) of this section to its U.S. income tax returns for the taxable years that include the distributions in liquidation; and

(*3*) The foreign distributee corporation attaches a copy of the property description contained in paragraph (b)(2)(i)(C)(2) of this section to its U.S. income tax return for the tax year that includes the date of distribution.

(B) *Qualifying property.* Property is used by the foreign distributee corporation in the conduct of a trade or business in the United States within the meaning of this paragraph (b)(2)(i) only if all income from the use of the property and all income or gain from the sale or exchange of the property would be subject to taxation under section 882(a) as effectively connected income. Also, stock held by a dealer as inventory or for sale in the ordinary course of its trade or business shall be treated as inventory and not as stock in the hands of both the domestic liquidating corporation and the distributee foreign corporation. Notwithstanding the foregoing, the exception provided in this paragraph (b)(2)(i) shall not apply to intangibles described in section 936(h)(3)(B).

(C) *Required statement.* The statement required by paragraph (b)(2)(i)(A) of this section shall be entitled "Required Statement under §1.367(e)–2(b)(2)(i)" and shall be prepared by the domestic liquidating corporation and signed under penalties of perjury by an authorized officer of the domestic liquidating corporation and by an authorized officer of the foreign distributee corporation. The statement shall contain the following items:

(*1*) *Declaration and certification.* A declaration that the distribution to the foreign distributee corporation is one to which the rules of this paragraph (b)(2)(i) apply and a certification that the domestic liquidating corporation and the foreign distributee corporation agree to all of the terms and conditions set forth in this paragraph (b)(2)(i).

(*2*) *Property description.* A description of all property distributed by the domestic liquidating corporation (irrespective of whether the property qualifies for nonrecognition). Such description shall be entitled "Master Property Description" and shall identify the property that continues to be used by the foreign distributee corporation in the conduct of a trade or business within the United States, including the location, adjusted basis, estimated fair market value, a summary of the method (including appraisals if any) used for determining such value, and the date of distribution of such items of property. The description shall also identify the property excepted from gain recognition under paragraphs (b)(2)(ii) and (iii) of this section.

(*3*) *Distributee identification.* An identification of the foreign distributee corporation, including its name and address, taxpayer identification number, residence, and place of incorporation.

(*4*) *Treaty benefits waiver.* With respect to property entitled to nonrecognition pursuant to this paragraph (b)(2)(i), a declaration by the foreign distributee corporation that it irrevocably waives any right under any treaty (whether or not currently in force at the time of the liquidation) to sell or exchange any item of such property without U.S. income taxation or at a reduced rate of taxation, or to derive income from the use of any item of such property without U.S. income taxation or at a reduced rate of taxation.

(*5*) *Statute of limitations extension.* An agreement by the domestic liquidating corporation and the foreign distributee corporation to extend the statute of limitations on assessments and collections (under section 6501) with respect to the domestic liquidating corporation on the distribution of each item of property until three years after the date on which all such items of property have ceased to be used in a trade or business within the United States, but in no event shall the extension be for a period longer than 13 years from the filing of the original U.S. income tax return for the taxable year of the last distribution of any such item of property. The agreement to extend the statute of limitation shall be executed on a Form 8838, "Consent to Extend the Time to Assess Tax Under Section 367—Gain Recognition Agreement."

(D) *Failure to file statement.* If a domestic liquidating corporation that would otherwise qualify for nonrecognition on the distribution of property under this paragraph (b)(2)(i) fails to file the statement described in paragraph (b)(2)(i)(C) of this section or files a statement that does not comply with the requirements of paragraph (b)(2)(i)(C) of this section, the Commissioner may treat the domestic liquidating corporation as if it had claimed nonrecognition under this paragraph (b)(2)(i) and met all the requirements of paragraph (b)(2)(i)(C) of this section, if such treatment is necessary to prevent the domestic liquidating corporation or the foreign distributee corporation from otherwise deriving a tax benefit by such failure.

(E) *Operating rules.* By the domestic liquidating corporation's claiming nonrecognition under this paragraph (b)(2)(i) and filing a statement described in paragraph (b)(2)(i)(C) of this section, the domestic liquidating corporation and the foreign distributee corporation agree to be subject to the rules of this paragraph (b)(2)(i)(E).

(*1*) *Gain or loss recognition by the foreign distributee corporation*—(*i*) *Taxable dispositions.* If, within the ten-year period from the date of a distribution of qualifying property, the foreign distributee corporation disposes of any qualifying property in a transaction subject to tax under section 882(a), then the foreign distributee corporation shall recognize such gain (or loss) and properly report it on a timely filed U.S. income tax return. If the foreign distributee corporation recognizes gain (or loss) under this paragraph (b)(2)(i)(E)(*1*)(*i*) and properly reports such gain (or loss) on its U.S. income tax return, then the domestic liquidating corporation shall not recognize gain attributable to such property under paragraph (b)(2)(i)(E)(*2*) of this section.

(*ii*) *Other triggering events.* If, within the ten-year period from the date of distribution, any qualifying property ceases to be used by the foreign distributee corporation in the conduct of a trade or business in the United States (other than by reason of a taxable disposition described in paragraph (b)(2)(i)(E)(*1*)(*i*) of this section, a nontriggering event described in paragraph (b)(2)(i)(E)(*4*) of this section, or a nontriggering transfer described in paragraph (b)(2)(i)(E)(*5*) of this section), then the foreign distributee corporation shall recognize gain (but not loss) attributable to such property and properly report it on a timely filed U.S. income tax return. If the foreign distributee corporation properly reports gain under this paragraph (or if such qualified property is not gain property on the date that it ceases to be used in the foreign distributee corporation's U.S. trade or business), then the domestic liquidating corporation shall not recognize gain attributable to such property under paragraph (b)(2)(i)(E)(*2*) of this section. The gain recognized under this paragraph (b)(2)(i)(E)(*1*)(*ii*) shall be an amount equal to the fair market value of the property on the date it ceases to be used in the foreign distributee corporation's U.S. trade or business less the foreign distributee corporation's adjusted basis in such property.

(2) *Gain recognition by the domestic liquidating corporation*—(*i*) *General rule.* If, within the ten-year period from the date of distribution, any qualifying property described in paragraph (b)(2)(i)(B) of this section ceases to be used by the foreign distributee corporation (or a qualifying transferee described in paragraph (b)(2)(i)(E)(*5*) of this section) in the conduct of a trade or business in the United States for any reason (including but not limited to the sale or exchange of such property or the removal of the property from conduct of the trade or business), then, except to the extent gain (or loss) is recognized under paragraph (b)(1)(i)(E)(*1*) of this section, the domestic liquidating corporation shall recognize the gain (but not loss) realized but not recognized upon the initial distribution of such item of property. The domestic liquidating corporation shall recognize gain pursuant to this paragraph (b)(2)(i)(E)(*2*)(*i*) on the amended U.S. income tax return described in paragraph (b)(2)(i)(E)(*2*)(*ii*) of this section.

(*ii*) *Amended return.* If gain recognition is required pursuant to paragraph (b)(2)(i)(E)(*2*)(*i*) of this section, the foreign distributee corporation shall file an amended U.S. income tax return on behalf of the domestic liquidating corporation for the year of the distribution of such item of property. On the amended return, the domestic liquidating corporation may use any losses (or credits) existing in the year of the distribution to offset the gain recognized pursuant to paragraph (b)(2)(i)(E)(*2*)(*i*) of this section (or the tax thereon), provided that the losses (or credits) were otherwise available in the year distribution and were not used in another year. The amended return shall be filed no later than the due date (including extensions) for the return of the foreign distributee corporation for the taxable year in which the property ceases to be used by the foreign distributee corporation in the conduct of a trade or business in the United States.

(*iii*) *Interest.* If the domestic liquidating corporation owes additional tax pursuant to paragraph (b)(2)(i)(E)(*2*)(*i*) of this section for the year of liquidation, then interest must be paid on that amount at the rates determined under section 6621. The interest due will be calculated from the due date of the domestic liquidating corporation's U.S. income tax return for the year of the distribution to the date on which the additional tax for that year is paid.

(*iv*) *Joint and several liability.* The foreign distributee corporation shall be jointly and severally liable for any tax owed by the domestic liquidating corporation as a result of the application of this section, and shall succeed to the domestic liquidating corporation's agreement to extend the statute of limitations on assessments and collections under section 6501.

(*3*) *Schedule for property no longer used in a U.S. trade or business.* If qualifying property (other than inventory) ceases to be used by the foreign distributee corporation in the conduct of a U.S. trade or business in the ten-year period beginning on the date of distribution of such property from the domestic liquidating corporation to the foreign distributee corporation, then the foreign distributee corporation shall list on a separate schedule (attached to its U.S. income tax return for the year of cessation) all such qualifying property. For purposes of this paragraph (b)(2)(i)(E)(*3*), property ceases to be used in a U.S. trade or business whenever such property is sold, exchanged, or otherwise removed from the U.S. trade or business, irrespective of whether the domestic liquidating corporation filed an amended return under paragraph (b)(2)(i)(E)(*2*) of this section, and irrespective of whether the property ceases to be used in the foreign distributee corporation's U.S. trade or business by virtue of a nontriggering event described in paragraph (b)(2)(i)(E)(*4*) of this section or a nontriggering transfer described in paragraph (b)(2)(i)(E)(*5*) of this section.

(4) *Nontriggering events*—(*i*) *Conversions, certain exchanges, and abandonment.* Gain (or loss) under this paragraph (b)(2)(i)(E) shall not be triggered if qualifying property described in paragraph (b)(2)(i)(B) of this section is involuntarily converted into, or exchanged for, similar qualifying property used in the conduct of a trade or business in the United States, to the extent such conversion or exchange qualifies for nonrecognition under sections 1033 or 1031. Also, the abandonment or disposal of worthless or obsolete property shall not trigger gain (or loss) under this paragraph (b)(2)(i)(E).

(*ii*) *Amendment to Master Property Description.* If the foreign distributee corporation acquires replacement property by virtue of a conversion or exchange of the qualifying property under this paragraph (b)(2)(i)(E)(*4*), then the foreign distributee corporation shall attach to its U.S. income tax return for the year of the acquisition such replacement property a schedule entitled "Amendment to Master Property Description Required by §1.367(e)–2(b)(2)(i)" that lists the replacement property and the property being replaced.

(*5*) *Nontriggering transfers to qualified transferees*. Gain (or loss) under this paragraph (b)(2)(i)(E) will not be triggered if qualifying property described in paragraph (b)(2)(i)(B) of this section is transferred to another person (qualified transferee) in a transaction qualifying for nonrecognition under the Internal Revenue Code (other than transactions described in paragraphs (b)(2)(i)(E)(4)(i) and (c)(1) of this section), if–

(*i*) The qualified transferee (and all other subsequent qualified transferees), immediately thereafter and for the ten-year period beginning on the date of the initial distribution of such qualifying property from the domestic liquidating corporation to the foreign distributee corporation, uses the property in the conduct of a trade or business in the United States;

(*ii*) The foreign distributee corporation (or its successor in interest) prepares and attaches to its U.S. income tax return for the year of transfer a statement entitled "Required Statement under §1.367(e)–2(b)(2)(i)(E)(5) for Property Transferred to a Qualified Transferee" that is signed under penalties of perjury by an authorized officer of the foreign distributee corporation and by a person similarly authorized by the qualified transferee;

(*iii*) The statement described in paragraph (b)(2)(i)(E)(*5*)(*ii*) of this section shall contain a description of all qualifying property transferred by the foreign distributee corporation (or qualified transferee) to the qualified transferee (or subsequent qualified transferee);

(*iv*) The statement described in paragraph (b)(2)(i)(E)(5)(*ii*) of this section shall also contain an identification of the qualified transferee (or subsequent qualified transferee), including its name and address, taxpayer identification number, residence, and place of incorporation (if applicable);

(*v*) The statement described in paragraph (b)(2)(i)(E)(*5*)(*ii*) of this section shall also contain a declaration by the qualifying transferee (or subsequent qualifying transferee) that it irrevocably waives any right under any treaty (whether or not currently in force at the time of the liquidation) to sell or exchange any item of such property without U.S. income taxation or at a reduced rate of taxation, or to derive income from the use of any item of such qualifying property without U.S. income taxation or at a reduced rate of taxation; and

(*vi*) A declaration that the transfer to the qualifying transferee (or subsequent qualifying transferee) is one to which the rules of this paragraph (b)(2)(i)(E)(*5*) apply and a certification that the foreign distributee corporation (or its successor in interest) and the qualifying transferee (or subsequent qualifying transferee) agree to all of the terms and conditions set forth in paragraph (b)(2)(i)(E)(*1*) of this section, replacing "foreign distributee corporation" with "qualifying transferee" and replacing references to "section 882(a)" with "section 871(b)" (as the case may be).

(ii) *Distribution of certain U.S. real property interests.* A domestic liquidating corporation shall not recognize gain (or loss) under paragraph (b)(1) of this section on the distribution of a U.S. real property interest (other than stock in a former U.S. real property holding corporation that is treated as a U.S. real property interest for five years under section 897(c)(1)(A)(ii)). If property distributed by the domestic liquidating corporation is a U.S. real property interest that qualifies for nonrecognition under this paragraph (b)(2)(ii) in addition to nonrecognition provided by paragraph (b)(2)(i) of this section, then the domestic liquidating corporation shall secure nonrecognition pursuant to this paragraph (b)(2)(ii) and not pursuant to the provisions of paragraph (b)(2)(i) of this section.

(iii) *Distribution of stock of domestic subsidiary corporations*—(A) *Conditions for nonrecognition.* A domestic liquidating corporation shall not recognize gain or loss under paragraph (b)(1) of this section on a distribution of stock of an 80 percent domestic subsidiary corporation, if the domestic liquidating corporation attaches a statement described in paragraph (b)(2)(iii)(D) of this section to its U.S. income tax return for the year of the distribution of such stock. For purposes of this paragraph (b)(2)(iii), a corporation is an 80 percent domestic subsidiary corporation, if—

(*1*) The subsidiary corporation is a domestic corporation (but not a foreign corporation that has made an election under section 897(i) to be treated as a U.S. corporation for purposes of section 897);

(*2*) The domestic liquidating corporation owns (directly) at least 80 percent of the total voting power of the stock of such corporation; and

(*3*) The domestic liquidating corporation owns (directly) at least 80 percent of the total value of all stock of such corporation.

(B) *Exceptions when the liquidating corporation is a U.S. real property holding corporation.* If the domestic liquidating corporation is a U.S. real property holding corporation (as defined in section 897(c)(2)) at the time of liquidation (or was a U.S. real property holding corporation with respect to the foreign distributee corporation during the five year period ending on the date of liquidation), then the exception in paragraph (b)(2)(iii)(A) of this section shall apply only to the distribution of stock of an 80 percent domestic subsidiary corporation that is a U.S. real property holding corporation (as defined in section 897(c)(2)) at the time of the liquidation and immediately thereafter.

(C) *Anti-abuse rule.* (*1*) The exception in paragraph (b)(2)(iii)(A) of this section shall not apply, if a principal purpose of the distribution of the 80 percent domestic subsidiary corporation's stock is the avoidance of U.S. tax that would have been imposed on the domestic liquidating corporation's disposition of such stock (directly or indirectly) to an unrelated party. A distribution may have a principal purpose of tax avoidance even though the tax avoidance purpose is outweighed by other purposes (taken together or separately).

(*2*) For purposes of paragraph (b)(2)(iii)(C)(*1*) of this section, a distribution of stock of the 80 percent domestic subsidiary corporation will be deemed to have been made pursuant to a plan, one of the principal purposes of which was the avoidance of U.S. tax, if the foreign distributee corporation disposes of any such stock within two years of such distribution. The rule in this paragraph (b)(2)(iii)(C)(*2*) will not apply if the foreign distributee corporation can demonstrate to the satisfaction of the Commissioner that a principal purpose of the liquidation was not the avoidance of U.S. tax.

(D) *Required statement.* The statement required by paragraph (b)(2)(iii)(A) of this section shall be entitled "Required Statement under §1.367(e)–2(b)(2)(iii) for Stock of 80 Percent Domestic Subsidiary Corporations" and shall be prepared by the domestic liquidating corporation and shall be signed under penalties of perjury by an authorized officer of the domestic liquidating corporation and by an authorized officer of the foreign distributee corporation. The required statement shall contain a certification that states that if the foreign distributee corporation disposes of any stock subject to paragraph (b)(2)(iii)(A) of this section in a transaction described in paragraph (b)(2)(iii)(C) of this section, then the domestic liquidating corporation shall recognize all realized gain attributable to such stock at the time of distribution, and the domestic liquidating corporation (or the foreign distributee corporation on behalf of the domestic liquidating corporation) shall file a U.S. income tax return (or amended U.S. income tax return, as the case may be) for the year of distribution reporting the gain attributable to such stock.

(3) *Other consequences*—(i) *Distributee basis in property.* The foreign distributee corporation's basis in property subject to this paragraph (b) shall be the same as the domestic liquidating corporation's basis in such property immediately before the liquidation, increased by any gain, or reduced by any loss recognized by the domestic liquidating corporation on such property pursuant to paragraph (b)(1) of this section. In no case, however, will the foreign distributee corporation's adjusted basis in distributed property exceed the fair market value of such property at the time of liquidation.

(ii) *Reporting under section 6038B.* Section 6038B and the regulations thereunder apply to a domestic liquidating corporation's transfer of property to a foreign distributee corporation under section 367(e)(2).

(iii) *Other rules.* For other rules that may be applicable, see sections 1248, 897, and 381.

(c) *Distribution by a foreign corporation*—(1) *General rule—gain and loss not recognized.* If a foreign corporation (foreign liquidating) makes a distribution of property in complete liquidation under section 332 to a foreign corporation (foreign distributee) that meets the stock ownership requirements of section 332(b) with respect to stock in the foreign liquidating corporation, then, except as provided in paragraph (c)(2) of this section, section 337(a) and (b)(1) shall apply and the foreign liquidating corporation shall not recognize gain (or loss) on the distribution under section 367(e)(2). If a foreign liquidating corporation distributes a partnership interest (whether foreign or domestic), then such corporation shall be treated as having distributed a proportionate share of partnership property in accordance with the principles of paragraph (b)(1)(iii) of this section.

(2) *Exceptions*—(i) *Property used in a U.S. trade or business*—(A) *General rule.* A foreign liquidating corporation (including a corporation that has made an effective election under section 897(i)) that makes a distribution described in paragraph (c)(1) of this section shall recognize gain on the distribution of qualified prop-

erty, as described in paragraph (b)(2)-(i)(B) of this section (other than U.S. real property interests), that is used by the foreign liquidating corporation in the conduct of a trade or business within the United States at the time of distribution.

(B) *Ten-year active U.S. business exception.* A foreign liquidating corporation shall not recognize gain under paragraph (c)(2)(i)(A) of this section, if—

(*1*) The foreign distributee corporation, immediately thereafter and for the ten-year period beginning on the date of the distribution of such property, uses the property in the conduct of a trade or business in the United States;

(*2*) The foreign distributee corporation is not entitled to benefits under a comprehensive income tax treaty (this requirement shall apply only if the foreign liquidating corporation (or predecessor corporation) was not entitled to benefits under a comprehensive income tax treaty); and

(*3*) The foreign liquidating corporation and foreign distributee corporation attach the statement described in paragraph (c)(2)(i)(C) of this section to their U.S. income tax returns for their taxable years that include the distribution.

(C) *Required statement.* The statement required by paragraph (c)(2)(i)(B)(3) of this section shall be entitled "Required Statement under §1.367(e)–2(c)(2)(i)," shall be prepared by foreign liquidating corporation, shall be signed under penalties of perjury by an authorized officer of the foreign liquidating corporation and by an authorized officer of the foreign distributee corporation, and shall be identical to the statement described in paragraph (b)(2)(i)(C) of this section, except that "§1.367(e)–2(c)(2)(i)(B)" shall be substituted for references to "§1.367(e)–2(b)-(2)(i)" and "foreign liquidating corporation" shall be substituted for "domestic liquidating corporation" each time it appears. References in the rules of paragraph (b)(2)(i)(C) of this section to various rules in paragraph (b) of this section shall be applied as if such references were to this paragraph (c). However, the statement described in this paragraph (c)(2)-(i)(C) shall be modified as follows:

(*1*) The foreign distributee corporation shall not be required to waive its income tax treaty benefits as required by §1.367(e)–2(b)(2)(i)(C)(*4*), unless—

(*i*) The foreign liquidating corporation was required to waive its treaty benefits under paragraph (b)(2)(i)(C)(4) of this section in connection with the distribution of such property in a prior liquidation distribution subject to the provisions of this section; or

(*ii*) The foreign distributee corporation is entitled benefits under a treaty to which the foreign liquidating corporation was not entitled.

(*2*) If the foreign distributee is required to waive treaty benefits because of paragraph (c)(2)(i)(C)(*1*)(*ii*) of this section, then the foreign distributee shall only be required to waive benefits that were not available to the foreign liquidating corporation (or a predecessor corporation) prior to liquidation.

(*3*) The property description described in paragraph (b)(2)(i)(C)(*2*) of this section shall include only the qualified U.S. trade or business property described in paragraph (c)(2)(i) of this section.

(D) *Operating rules.* By the foreign liquidating corporation's claiming nonrecognition under paragraph (c)(2)(i)(B) of this section and filing a statement described in paragraph (c)(2)(i)(C) of this section, the foreign liquidating corporation and the foreign distributee corporation agree to be subject to the rules of paragraph (c)(2)(i) of this section, as well as the rules of paragraphs (b)(2)(i)(D) and (E) of this section. In applying the rules of paragraphs (b)(2)(i)(D) and (E) of this section, "foreign liquidating corporation" shall be used instead of "domestic liquidating corporation" each time it appears. References in the rules of paragraphs (b)(2)(i)(D) and (E) of this section to various rules in paragraph (b) of this section shall be applied as if such references were to this paragraph (c).

(ii) *Property formerly used in a United States trade or business.* A foreign liquidating corporation that makes a distribution described in paragraph (c)(1) of this section shall recognize gain (but not loss) on the distribution of property (other than U.S. real property interests) that had ceased to be used by the foreign liquidating corporation in the conduct of a U.S. trade or business within the ten-year period ending on the date of distribution and that would have been subject to section 864(c)(7) had it been disposed. Section 864(c)(7) shall govern the treatment of any gain recognized on the distribution of assets described in this paragraph as income effectively connected with the conduct of a trade or business within the United States.

(3) *Other consequences*—(i) *Distributee basis in property.* The foreign distributee corporation's basis in property subject to this paragraph (c) shall be the same as the foreign liquidating corporation's basis in such property immediately before the liquidation, increased by any gain, or reduced by any loss recognized by the foreign liquidating corporation on such property, pursuant to paragraph (c)(2) of this section. In no event, however, will the foreign distributee corporation's adjusted basis in distributed property exceed the fair market value of such property at the time of liquidation.

(ii) *Other rules.* For other rules that may apply, see sections 367(b) and 381.

(d) *Anti-abuse rule.* The Commissioner may require either a domestic liquidating corporation or a foreign liquidating corporation to recognize gain on a distribution in liquidation described in paragraph (b) or (c) of this section (or treat the liquidating corporation as if it had recognized loss on a distribution in liquidation), if a principal purpose of the liquidation is the avoidance of U.S. tax (including, but not limited to, the distribution of a liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax). A liquidation may have a principal purpose of tax avoidance even though the tax avoidance purpose is outweighed by other purposes (taken together or separately).

(e) *Effective date.* This section shall be applicable to distributions occurring 30 days after August 9, 1999 or, if taxpayer so elects, to distributions in taxable years ending after August 8, 1999.

Par. 4. Section 1.6038B-1 is amended by revising the fourth sentence of paragraph (a), the first sentence of paragraph (b)(1)(i), and paragraphs (d), (e), and (g) to read as follows:

§1.6038B–1 Reporting of certain transactions to foreign corporations.

(a) * * * Section 1.6038B-1(e) describes the filing requirements for property transfers described in section 367(e). * * *

(b) *Time and manner of reporting*—(1) *In general*—(i) *Reporting procedure.* Except for stock or securities qualifying under the special reporting rule of paragraph (b)(2) of this section, or cash, which is subject to special rules contained in paragraph (b)(3) of this section, any U.S. person that makes a transfer described in section 6038B(a)(1)(A), 367(d), or 367(e), is required to report pursuant to section 6038B and the rules of this section and must attach the required information to Form 926, "Return by Transferor of Property to a Foreign Corporation." * * *

* * * * *

(d) [Reserved]. For further guidance, see §1.6038B–1T(d).

(e) *Transfers subject to section 367(e)*—(1) *In general.* If a domestic corporation (distributing corporation) makes a distribution described in section 367(e)(1) or section 367(e)(2), the distributing corporation must comply with the reporting requirements of this paragraph (e). Unless otherwise provided in this section, a distributing corporation making a distribution described in sections 367(e)(1) or 367(e)(2) must file a Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation (under section 367)," as amended and modified by this section.

(2) *Reporting requirements for section 367(e)(1) distributions of domestic controlled corporations.* A domestic distributing corporation making a distribution of the stock or securities of a domestic corporation under section 355 is not required to file a Form 926, as described in paragraph (e)(1) of this section, and shall have no other reporting requirements under section 6038B.

(3) *Reporting requirements for section 367(e)(1) distributions of foreign controlled corporations.* If the distributing corporation makes a section 355 distribution of the stock or securities of a foreign controlled corporation to distributee shareholders who are not qualified U.S. persons, as defined in §1.367(e)–1(b)(1), then the distributing corporation shall complete Part 1 of the Form 926 and attach a signed copy of such form to its U.S. income tax return for the year of the distribution. The distributing corporation shall also attach to its U.S. income tax return for the year of distribution a statement signed under the penalties of perjury entitled, "Addendum to Form 926." The addendum shall contain a brief description of the transaction, state the number of shares distributed to distributees who are not qualified U.S. persons (applying the rules contained in §1.367(e)–1(d)), and state the basis and fair market value of the distributed stock or securities (including a list stating the amounts that were distributed to distributees who were not qualified U.S. persons and distributees who were qualified U.S. persons).

(4) *Reporting rules for section 367(e)(2) distributions by domestic liquidating corporations.* If the distributing corporation makes a distribution of property in complete liquidation under section 332 to a foreign distributee corporation that meets the stock ownership requirements of section 332(b) with respect to the stock of the distributing corporation, then the distributing corporation shall complete a Form 926 and attach a signed copy of such form to its U.S. income tax return for the year of the distribution. The property description contained in Part III of the Form 926 shall contain a description of all property distributed by the liquidating corporation (regardless of whether the property qualifies for nonrecognition). The description shall also identify the property excepted from gain recognition under §1.367(e)–2(b)(2)(ii) and (iii). If the distributing corporation distributes property that will be used by the foreign distributee corporation in a U.S. trade or business and the distributing corporation does not recognize gain on such distribution under §1.367(e)–2(b)(2)(i), then the distributing corporation may satisfy the requirements of this section by completing Part 1 of the Form 926, noting thereon that the information required by the Form 926 is contained in the statement required by §1.367(e)–2(b)(2)(i)(C)(*2*), and attaching a signed copy of the Form 926 to its U.S. income tax return for the year of the distribution.

* * * * *

(g) *Effective dates.* This section applies to transfers occurring on or after July 20, 1998, except paragraph (e) of this section, which applies to transfers that are subject to §§1.367(e)–1(f) and 1.367(e)–2(e). See §1.6038B–1T for transfers occurring prior to July 20, 1998. See also §1.6038B–1T(e) in effect prior to August 9, 1999, (as contained in 26 CFR part 1 revised April 1, 1999) for transfers described in section 367(e) that are not subject to §§1.367(e)–1(f) and 1.367(e)–2(e).

Par. 5. Section 1.6038B–1T is amended by revising the section heading, revising paragraph (e) and revising the first sentence of paragraph (g), to read as follows.

§1.6038B–1T Reporting of certain transactions to foreign corporations (temporary).

* * * * *

(e) [Reserved] For further guidance, see §1.6038B–1(e).

* * * * *

(g) *Effective date.* This section applies to transfers occurring after December 31, 1984. * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In §602.101, paragraph (b) is amended in the table by removing the entries for 1.367(e)–1T and 1.367(e)–2T, revising the entry for 1.6038B–1, and adding entries in numerical order to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.367(e)–1	1545–1487
1.367(e)–2	1545–1487
* * * * *	
1.6038B–1	1545–1487 1545–1615
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved 7/29/1999.

Donald C. Lubbick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 6, 1999, 8:45 a.m., and published in the issue of the Federal Register for August 9, 1999, 64 F.R. 43072)

Section 482.—Allocation of Income and Deductions Among Taxpayers

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

This revenue procedure addresses secondary adjustments under section 482 of the Internal Revenue Code. See Rev. Proc. 99–32, page 296.

Section 643.—Definitions Applicable to Subparts A, B, C, and D

26 CFR 1.643(h)–1: Distribution by certain foreign trusts through intermediaries.

T.D. 8831

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Inbound Grantor Trusts With Foreign Grantors

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations implementing sections 672(f) and 643(h) of the Internal Revenue Code, as amended by the Small Business Job Protection Act of 1996, which relate to the application of the grantor trust rules to certain trusts established by foreign persons. These regulations affect primarily U.S. persons who are beneficiaries of trusts established by foreign persons. This document also contains temporary regulations defining the term *grantor* for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code. The text of these temporary regulations serves as the text of the proposed regulations set forth in the notice of proposed rulemaking published in REG–252487–96, on page 303.

DATES: *Effective Date:* These regulations are effective August 10, 1999.

Applicability Dates: For dates of applicability of §1.643(h)–1, see §1.643(h)–1(h). For dates of applicability of §1.671–2T(e), see §1.671–2T(e)(7). For dates of applicability of §§1.672(f)–1 through 1.672(f)–5, see §§1.672(f)–1(c), 1.672(f)–2(e), 1.672(f)–3(e), 1.672(f)–4(h), and 1.672(f)–5(c).

FOR FURTHER INFORMATION CONTACT: M. Grace Fleeman (202) 622-3880 concerning the regulations generally, and James A. Quinn (202) 622-3060 concerning §1.671–2T(e) and §1.672(f)–1 (not toll-free numbers).

SUPPLEMENTARY INFORMATION

Background

On June 5, 1997 (62 F.R. 37819) Treasury and the IRS published a notice of proposed rulemaking (REG–252487–96) under sections 643(h), 671, 672(f), and 7701 of the Internal Revenue Code (Code). Comments responding to the notice were received and a public hearing was held on August 27, 1997. After consideration of the comments, the proposed regulations under sections 643(h) and 672(f) are adopted as final regulations as revised by this Treasury decision. The proposed regulations under section 671 are issued as revised by this Treasury decision as temporary regulations. The revisions are discussed below. The proposed regulations under section 7701 are withdrawn. The temporary regulations under section 671 are also being issued as proposed regulations published in REG–252487–96, on page 303.

Explanation of Provisions and Revisions

1. *Comments and Changes to §1.643(h)–1: Distributions by Certain Foreign Trusts Through Intermediaries*

Under the proposed regulations, any amount that was derived, directly or indirectly, by a U.S. person from a foreign trust through an intermediary generally was deemed to have been transferred directly by the foreign trust to the U.S. person if any one of three specified conditions was satisfied. In cases where the transfer from the intermediary to the U.S. person did not occur in the same taxable year of the U.S. person as the transfer from the foreign trust to the intermediary, the proposed regulations looked to generally applicable agency principles to determine when the transfer to the U.S. person was deemed to occur.

Commenters said the proposed rules were too broad and could reach virtually any transfer made to a U.S. person by any person who has received a distribution from a foreign trust. They suggested that the basic requirement for treating a transfer to a U.S. person as a transfer directly from a foreign trust should be the existence of an intention to avoid U.S. tax. Alternatively, they said there should at least be a time limitation so that the rule would not apply to a transfer of property received from a foreign trust more than, for example, one year before the transfer to the U.S. person. In addition, they said the proposed rule relying on generally applicable agency principles for determining whether an intermediary is the agent of the foreign trust or of the U.S. person would be difficult to apply because different countries have different laws and the U.S. person should be taxed prior to receipt only if the intermediary is clearly a nominee or agent for the U.S. person.

In response to the comments, the final regulations treat any property (including cash) that is transferred to a U.S. person by an intermediary who has received property from a foreign trust as property transferred directly by the foreign trust to the U.S. person if the intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax. A transfer of property will be deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax if all of certain specified factors are present. However, the Commissioner may find that a transfer was made pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax whether or not any of the specified factors is present.

The factors that will cause a transfer to be deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax are the following: (i) the U.S. person is related to a grantor of the foreign trust or has another relationship with a grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor of the foreign trust would make a gratuitous transfer to the U.S. person; (ii) the U.S. person receives from the intermediary, within the period beginning twenty-four months before and ending twenty-four months after the intermediary's receipt of property from the foreign trust, either the property the intermediary received from the foreign trust, proceeds from such property, or property in substitution for such property; and (iii) the U.S. person cannot demonstrate to the satisfaction of the Commissioner that (A) the intermediary has a relationship with the U.S. person that establishes a reasonable basis for concluding that the intermediary would make a gratuitous transfer to the U.S. person, (B) the intermediary acted independently of the grantor and the trustee, (C) the intermediary is not an agent of the U.S. person under generally applicable U.S. agency principles, and (D) the U.S. person timely complied with the reporting requirement of section 6039F, if applicable, if the intermediary is a foreign person. See Notice 97–34 (1997–1 C.B. 422).

The final regulations also have been modified with respect to the application of generally applicable agency principles. Under the final regulations, property is treated as transferred to the U.S. person in the year it is actually transferred to the U.S. person by the intermediary unless the Commissioner determines, or the taxpayer can demonstrate to the satisfaction of the Commissioner, that the intermediary is an agent of the U.S. person under generally applicable agency principles, in which case the property will be treated as transferred to the U.S. person by the trust in the year the property was transferred to the intermediary by the trust. As a corollary, the final regulations provide that the fair market value of the property is determined as of the date of the transfer to the U.S. person, unless the intermediary is treated as an agent of the U.S. person, in which case the fair market value will be determined as of the date of the transfer to the intermediary. Examples illustrate the effect of changes in the fair market value between the date of the transfer to the intermediary and the date of the transfer to the U.S. person.

The final regulations clarify that they apply only to gratuitous transfers. They also clarify that if property is treated as transferred directly by a foreign trust to a U.S. person pursuant to the regulations, the same property will not be taken into account in computing the gross income of the intermediary (if such property would otherwise be required to be so taken into account).

The final regulations under section 643(h) are applicable to transfers made to U.S. persons after August 10, 1999.

2. *Comments and Changes to §1.671– 2(e): Definition of Grantor*

The proposed regulations provided a definition of grantor for purposes of part I of subchapter J, chapter 1 of the Code. This document replaces the proposed regulations with temporary regulations that are effective August 10, 1999. These temporary regulations are also being issued as proposed regulations published elsewhere in this issue of the **Federal Register.** In accordance with section 7805(e)(2), the temporary regulations will expire before August 12, 2002.

Under the original proposed regulations, a grantor was defined to include any person to the extent such person either (i) creates a trust or (ii) directly or indirectly makes a gratuitous transfer to a trust. Commenters questioned why a nominal creator who has made no transfer to a trust should be treated as a grantor and asked for an explanation of the tax significance of such treatment.

Treating a nominal creator as a grantor ensures that someone will be responsible for reporting the creation of a foreign trust by a U.S. person even if the trust is not immediately funded. See section 6048(a)(3)(A)(i) and (a)(4)(A). At the same time, Treasury and the IRS believe that an accommodation grantor, such as an attorney who creates a trust on behalf of a client, (although a grantor) should not be treated as an owner of the trust. Accordingly, the temporary regulations provide that a person who either creates a trust, or funds a trust with an amount that is directly repaid to such person within a reasonable period of time, but who makes no other transfers to the trust that constitute gratuitous transfers, will not be treated as an owner of any portion of the trust under sections 671 through 677 or 679.

Commenters also questioned a provision in the proposed regulations that treated a distribution from one trust to another trust that is a beneficiary of the first trust as a gratuitous transfer, with the result that the first trust was a grantor of the second trust. Under the temporary regulations, if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally is treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, such person is treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Code. (These rules do not affect the determination of whether or not the gratuitous transfer from the transferor trust is a distribution subject to sections 651 or 661.)

The proposed regulations provided that a person who acquires an interest in a fixed investment trust from a grantor of the trust also will be treated as a grantor of the trust. In response to comments received, the temporary regulations extend the same treatment to persons who acquire an interest in a liquidating trust or an environmental remediation trust.

The temporary regulations include a new section that applies to gratuitous transfers to trusts by partnerships and corporations. If the transfer is entered into for a business purpose of the partnership or corporation, the partnership or corporation, as the case may be, generally is treated as the grantor of the trust. However, if the transfer is not entered into for a business purpose of the partnership or corporation — for example, if it is for the personal purposes of one or more of the partners or shareholders — the transfer is treated as a constructive distribution to such partners or shareholders under federal tax principles, and the partners or shareholders, as the case may be, are treated as the grantors of the trust. See, for example, *Epstein v. Commissioner,* 53

T.C. 459 (1969), acq. on another issue, 1970–2 C.B. xix.

Commenters asked for guidance concerning the identification of the grantor when the property contributed to the trust is jointly owned. These temporary regulations do not provide specific guidance on the treatment of joint owners that contribute property to a trust. Treasury and the IRS invite comments with specific examples of areas that may need clarification, such as, for example, the treatment of community property or the joint ownership of property by noncitizen spouses.

3. *Comments and Changes to §1.672(f)–1: Foreign Persons Not Treated as Owners*

The proposed regulations prescribed a two-step analysis for implementing the general rule of section 672(f). First, the grantor trust rules other than section 672(f) (the basic grantor trust rules) were applied to determine the worldwide amount and the U.S. amount. Then, the trust was treated as partially or wholly owned by a foreign person based on an annual year-end comparison of the worldwide amount and the U.S. amount. Commenters suggested that the two-step analysis was unnecessarily complex and questioned whether it might produce results that were unintended or inconsistent with the statute.

In response to these concerns, the final regulations provide that the grantor trust rules other than section 672(f) must be applied first to determine whether, under such rules, any portion of the trust would be treated as owned by a person other than a U.S. citizen or resident or domestic corporation. The determination of the portion of the trust that is treated as owned by a grantor or other person is to be made based on the terms of the trust and the application of the grantor trust rules as found in §1.671–1 et seq. If it is determined that any portion of the trust would be treated as owned by a person other than a U.S. citizen or resident or domestic corporation, such person will be treated as the owner of such portion only if such person is a foreign corporation described in §1.672(f)–2(a) or if such portion of the trust qualifies for one of the exceptions in §1.672(f)–3.

The final regulations under the general rule are generally applicable to taxable years of a trust beginning after August 10, 1999.

4. *Comments and Changes to §1.672(f)–2: Certain Foreign Corporations*

Under the proposed regulations, a controlled foreign corporation (CFC) that created or funded a trust was treated as a domestic corporation for purposes of section 672(f) only to the extent the trust's income was subpart F income that was currently taken into account in computing the gross income of a U.S. citizen, U.S. resident, or domestic corporation. There were similar rules for passive foreign investment companies (PFICs) and foreign personal holding companies (FPHCs). Commenters questioned whether the proposed rules were consistent with the statutory antideferral regime and the legislative history. There also were suggestions that the proposed rules should not apply where a CFC is wholly owned, directly or indirectly, by U.S. shareholders. In addition, there were requests for simplification of the rules pertaining to annual fluctuations in the portion of a trust that is treated as owned by the grantor.

In response to the comments, Treasury and the IRS have developed rules that are narrowly targeted to potentially abusive situations and therefore are not inconsistent with the antideferral regime. Under the final regulations, if the owner of a trust upon application of the grantor trust rules without regard to section 672(f) is a CFC, PFIC, or FPHC, the CFC, PFIC, or FPHC, as the case may be, will be treated as a domestic corporation for purposes of applying the general rule of §1.672(f)–1. Consequently, a CFC, PFIC, or FPHC generally will be treated as an owner of a trust if it would be so treated under sections 671 through 678 without regard to section 672(f). A CFC, PFIC, or FPHC will be treated as a domestic corporation solely for purposes of applying the general rule of §1.672(f)–1. Thus, a CFC, PFIC, or FPHC will be treated as a foreign corporation for purposes of §1.672(f)–4, which is discussed below in part 6 of this explanation.

If a trust to which a CFC, PFIC, or FPHC has made a gratuitous transfer makes a gratuitous transfer to a U.S. person, the CFC, PFIC, or FPHC, as the case may be, will be treated as a foreign corporation for purposes of determining how the transfer will be treated in the hands of the U.S. person, and the rules of §1.672(f)–4(c) will apply. If a trust that a CFC, PFIC, or FPHC is treated as owning under section 678 makes a gratuitous transfer to a U.S. person, the rules of §1.672(f)–4(c) will apply as if the CFC, PFIC, or FPHC had made a gratuitous transfer to the trust.

The final regulations for CFCs, PFICs, and FPHCs are generally applicable to taxable years of shareholders of CFCs, PFICs, and FPHCs beginning after August 10, 1999 and taxable years of CFCs, PFICs, and FPHCs ending with or within such taxable years of the shareholders.

5. *Comments and Changes to §1.672(f)–3: Exceptions To General Rule*

A. Certain Revocable Trusts

Under the proposed regulations, the general rule of §1.672(f)–1(a) did not apply to any portion of a trust if the power to revest absolutely in the grantor title to such portion was exercisable solely by the grantor without the approval or consent of any other person for a period or periods aggregating 183 days or more during the taxable year of the trust. The 183-day rule is targeted at potentially abusive situations in which a power to revest is so limited that it is not likely to be exercised.

In response to comments received, the final regulations clarify that if the first or last taxable year of the trust is less than 183 days, the revocable trust exception will apply if the grantor has a power to revest on each day of the first or last taxable year (including the year of the grantor's death), as the case may be. The final regulations also clarify that, consistent with the principle that statutory exceptions should be construed narrowly, if a trust fails to qualify for the revocable trust exception in a particular year, the exception cannot apply in a later year even if the requirements would otherwise be satisfied in such later year.

Commenters asked whether the revocable trust exception continues to apply if the grantor becomes incapacitated. The final regulations provide that the exception will continue to apply if, but only if, there is a guardian or other person who has unrestricted authority to exercise the necessary power on the grantor's behalf.

Some commenters disagreed with the result in §1.672(f)–3(a)(4) *Example 3* of the proposed regulations, which concluded that the revocable trust exception does not apply where the grantor of the trust can replace the trustee, who is not a related or subordinate party, at any time for any reason. They said the example was inconsistent with the existing grantor trust rules. See, e.g., §1.674(d)–2(a). After careful consideration, Treasury and the IRS have concluded that Example 3 is consistent with the purposes of section 672(f) and should be retained.

Commenters raised a number of issues concerning the grandfather rules in §1.672(f)–3(a)(2) and (b)(4) of the proposed regulations for certain trusts that were in existence on September 19, 1995. In response to the comments, the final regulations confirm that physical separation of amounts that were gratuitously transferred to the trust after September 19, 1995, is not required. The final regulations further provide that initial separate accountings may be prepared at any time up until the due date (including extensions) for the tax return for the first taxable year of the trust beginning after August 10, 1999. In response to requests for more specific guidance, the final regulations provide that the grandfather rules apply only if any amounts that were gratuitously transferred to the trust after September 19, 1995, are treated as a separate portion of the trust that is accounted for under the rules of §1.671–3(a)(2).

B. Certain Trusts that Can Distribute Only to the Grantor or the Spouse of the Grantor

Under the proposed regulations, the general rule of §1.672(f)–1 did not apply if the only amounts distributable from a trust (or portion of a trust) during the lifetime of the grantor were amounts distributable to the grantor or the grantor's spouse. Treasury and the IRS contemplate that the fact that the grantor and his or her spouse might someday divorce or legally separate will be disregarded for purposes of determining whether the exception is applicable.

Under the proposed regulations, amounts distributable in discharge of a legal obligation of the grantor or the grantor's spouse generally were treated as amounts distributable to the grantor or the grantor's spouse. Commenters said these proposed rules were inconsistent with the manner in which distributions in discharge of obligations are treated in regulations promulgated under other provisions of the Code. For example, under sections 677(a) and 662(a)(2), there is no exception for obligations to family members that are not based on full and adequate consideration in money or money's worth. Commenters also said the proposed rules were likely to exclude most trusts from qualification for the exception because, in most jurisdictions, a trust provision that permits distributions to a particular person is construed to permit distributions to be made in satisfaction of that person's obligations, regardless of the source of the obligations.

Treasury and the IRS believe it is neither necessary nor appropriate for the regulations promulgated under the statutory exceptions to section 672(f) to be consistent with the regulations promulgated under other provisions of part I of subchapter J, chapter 1 of the Code. Section 672(f) reflects a policy determination that foreign persons should not be allowed "to affirmatively use the domestic anti-abuse rules concerning grantor trusts" to avoid U.S. tax on trust income distributed to U.S. beneficiaries. Dept. of the Treasury, General Explanations of the Administration's Revenue Proposals, at 12 (1995). Section 672(f) operates to implement that policy determination by providing that the grantor trust rules generally do not apply where their effect would be to treat a foreign person as the owner of any portion of a trust. S. Rep. No. 35, 104th Cong., 1st Sess. 161 (1995). The exceptions in section 672(f)(2) must be interpreted narrowly to preserve the primary operation of the general rule. See, for example, *Commissioner v. Clark*, 489 U.S. 726, 739 (1989) ("In construing provisions . . . in which a general statement of policy is qualified by an exception, we usually read the exception narrowly in order to preserve the primary operation of the provision.").

The final regulations continue to provide that a trust will not fail to qualify for the exception solely because amounts are distributable from the trust in discharge of a legal obligation of the grantor (or grantor's spouse). An obligation to a related person is not generally treated as a legal obligation unless it was contracted bona fide and for adequate and full consideration in money or money's worth. However, obligations to support certain individuals will be treated as legal obligations if the individual is either permanently and totally disabled or less than 19 years old. The final regulations expand the list of potentially eligible individuals to include certain individuals who are members of the grantor's (or grantor's spouse's) household and have as their principal place of abode the grantor's (or grantor's spouse's) home, but are not related to the grantor (or grantor's spouse) through one of the relationships listed in section 152(a)(1) through (8). The fact that amounts might become distributable from a trust to support an individual who is not described in the regulations will be disregarded if, at the time the applicability of the exception is being determined, the potential obligation is not reasonably expected to arise under the facts and circumstances.

Some commenters said the limitation in proposed §1.672(f)–3(b)(2)(ii) for legal obligations to related persons is not needed in the case of reinsurance trusts because, regardless of the sufficiency of the consideration for the reinsurance, the funds in a reinsurance trust can be utilized only to satisfy the legal obligations of the reinsurer (or will be distributed to the reinsurer). In addition, commenters pointed out that there already are other provisions, such as sections 482 and 845, that apply to related-party reinsurance arrangements.

The final regulations reserve on the application of the related-party rule to reinsurance trusts. Treasury and the IRS are looking carefully at this area, and they invite additional comments.

Commenters raised a number of issues concerning the grandfather rules in §1.672(f)–3(b)(4) of the proposed regulations. These issues are discussed above in connection with the grandfather rules under §1.672(f)–3(a)(2) of the proposed regulations.

C. Compensatory Trusts

The proposed regulations listed categories of trusts that constitute compensatory trusts, without regard to whether any portion of a particular trust would ever be treated as owned by the grantor or another person under the grantor trust rules. Treasury and the IRS are concerned that some taxpayers may find such a comprehensive list confusing. Accordingly, the final regulations provide that the trusts to which the compensatory trust exception applies are those to which the application of section 672(f) is likely to be relevant: (i) nonexempt employees' trusts described in section 402(b) and (ii) so-called "rabbi" trusts. Treasury and the IRS believe the issue of whether tax-exempt compensatory trusts can be treated as owned by a foreign person is moot because there are special statutory rules that govern those trusts.

Treasury and the IRS contemplate that a nonexempt employees' trust described in section 402(b) will be treated as owned by a beneficiary of the trust only to the extent provided in regulations section 1.402(b)–1(b)(6). See also proposed regulations §1.671–1(g) and §1.671–1(h), which were published in the **Federal Register** (61 F.R. 50778) on September 27, 1996, for proposed rules describing when an employer will be treated as an owner of any portion of a nonexempt employees' trust described in section 402(b) that is part of a deferred compensation plan.

The final regulations also provide that the Commissioner may designate additional categories of trusts to which the compensatory trust exception applies.

6. C*omments and Changes to §1.672(f)–4: Recharacterization of Purported Gifts*

The proposed regulations provided that a U.S. donee generally must treat a purported gift from a foreign corporation as a distribution from the foreign corporation unless the U.S. donee can establish that a U.S. citizen or resident alien is a shareholder of the transferor and that the U.S. citizen or resident took the amount into account for U.S. tax purposes and subsequently made a gift to the U.S. donee. Similar rules were proposed for purported gifts from partnerships (whether domestic or foreign). There were exceptions for charitable contributions to donees described in section 170(c) and for purported gifts that did not exceed $10,000.

Section 1.672(f)–4(c) of the proposed regulations provided rules for gratuitous transfers to U.S. donees from trusts created by partnerships or foreign corporations. Under the proposed regulations, if the partnership or foreign corporation was treated as the owner of the trust under the grantor trust rules, the transfer was treated as a purported gift from the partnership or foreign corporation. If the partnership or foreign corporation was not treated as the owner of the trust, the transfer was treated as an accumulation distribution from the trust unless the resulting U.S. tax liability was less than the U.S. tax that would be due if the transfer were treated as a purported gift from the partnership or foreign corporation.

Commenters said the proposed regulations were overly broad and exceeded the scope of the regulatory authority granted by Congress. They suggested that a purported gift from a partnership or foreign corporation should be treated as a deemed distribution to the partner or shareholder followed by a deemed transfer to the U.S. donee. Commenters also suggested that purported gifts should not be recharacterized as taxable distributions unless it appeared, based on all the facts and circumstances, that the partnership or foreign corporation was being used principally as a device to avoid U.S. tax.

Treasury and the IRS believe the basic approach taken by the proposed regulations is both necessary and appropriate to prevent the avoidance of the purposes of section 672(f). See Code section 672(f)(4) and (6). A rule that would recharacterize purported gifts only in situations where the partnership or foreign corporation was being used principally as a device to avoid U.S. tax would be unadministrable. It would place a nearly insurmountable burden on the IRS to obtain information, much of it outside the United States, and to establish that the partnership or foreign corporation was being used to avoid U.S. tax. Further, individuals do not normally receive gifts from partnerships and corporations. See, for example, *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

The final regulations leave the basic approach essentially unaltered, but expand the number of exceptions to the general rule. They retain the exception for cases where the U.S. donee can establish that a U.S. citizen or resident alien treated (and reported) the purported gift for U.S. tax purposes as a distribution from the partnership or foreign corporation and a subsequent gift to the donee. In response to the commenters' concerns, they provide an additional exception for cases where the U.S. donee can establish that a nonresident alien individual treated and reported the purported gift for purposes of the tax laws of the country in which the nonresident alien is resident as a distribution from the partnership or foreign corporation and a subsequent gift to the donee, provided the U.S. donee timely complied with the filing requirements of section 6039F, if applicable. Finally, they provide another new exception for purported gifts from domestic partnerships that are beneficially owned (within the meaning of §1.1441–1(c)(6)) exclusively by U.S. citizens or residents or domestic corporations.

In response to other comments, the final regulations clarify that a transfer to a U.S. donee that is a corporation will not be subject to the general rule of §1.672(f)–4(a) to the extent the donee can establish that the transfer was a contribution to capital. The final regulations also expand the scope of the charitable contribution exception to include a transfer from a transferor that has received a ruling or determination letter from the Internal Revenue Service recognizing its exempt status under section 501(c)(3), provided that the transfer was made pursuant to the transferor's exempt purpose, the ruling or determination letter has not been revoked or modified, and there has been no material change, inconsistent with exemption, in the character, purpose, or method of operation of the organization.

The final regulations revise the rules for gratuitous transfers to U.S. donees from trusts to which partnerships or foreign corporations have made gratuitous transfers. The revisions reflect the fact that, under U.S. domestic law principles, the partners or shareholders might be treated as grantors of the trust. See §1.671–2T(e)(4).

The final regulations also clarify that if the transferring partnership or foreign corporation receives some consideration from the U.S. donee, but the consideration is less than the fair market value of the property transferred, only the excess will be treated as a purported gift. Further, no portion will be treated as a purported gift if the U.S. donee can establish that the U.S. donee is neither related to a partner or shareholder of the transferor within the meaning of §1.643(h)–1(e) nor has another relationship with a partner or shareholder of the transferor such that there is a reasonable basis for concluding that the partner or shareholder would make a gratuitous transfer to the U.S. donee.

Commenters said the proposed regulations overturned an early Supreme Court decision, *Bogardus v. Commissioner*, 302 U.S. 34 (1937), which treated certain payments by an acquiring corporation in a reorganization that were paid at the instigation of former shareholders of the target corporation to employees and former employees of the target corporation as nontaxable gifts rather than as compensation. The result in *Bogardus* might well be different today under section 102(c)(1) (enacted in 1986), which provides that the exclusion from gross income for the value of property acquired by gift does not apply to any amount transferred by or for an employer to, or for the benefit of, an employee. Further, and more importantly, the payor corporation in *Bogardus* was a domestic corporation that did not treat the payments as a deductible expense and there was no avoidance of U.S. tax. Thus, *Bogardus* is distinguishable on its facts from a situation where a foreign corporation transfers property to a U.S. person who treats the transfer as a gift or bequest and there will be avoidance of U.S. tax if the purported gift is not recharacterized.

The final regulations for purported gifts are generally applicable to transfers made after August 10, 1999 by partnerships or foreign corporations, or by trusts to which partnerships or foreign corporations made gratuitous transfers after August 10, 1999.

7. *Comments and Changes to §1.672(f)–5: Special Rules*

Section 1.672(f)–5(b) of the proposed regulations provided that, for purposes of §1.672(f)–1, where the taxable year of a trust was different from the taxable year of a person who was taking an amount into account, the amount was taken into account for the taxable year of the person that included the last day of the taxable year of the trust. This rule was deleted from the final regulations, because it is no longer needed in light of the revisions to §1.672(f)–1, which are described above in part 3 of this explanation.

Section 1.672(f)–5(c) of the proposed regulations provided that, for purposes of §1.672(f)–4, a wholly owned business entity must be treated as a corporation, separate from its single owner. Absent this rule, an entity having a single owner could avoid the purported gift rule by electing to be disregarded, with the result that the purported gift would be received from the owner of the entity, rather than from the entity itself. The final regulations clarify that this special rule (renumbered as §1.672(f)–5(b)) applies solely for purposes of §1.672(f)–4. Thus, it does not apply for purposes of §§1.672(f)–1 through 1.672(f)–3 or §1.672(f)–5 or for purposes of any other provision of the Code or regulations.

Section 301.7701–2(c)(2)(iii) of the proposed regulations provided that, solely for purposes of applying the rules of section 672(f)(4), a wholly owned business entity will be treated as a corporation, separate from its owner. This provision, which repeated the rule in §1.672(f)–5(c) (renumbered as §1.672(f)–5(b)), is not included in the final regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on the regulation's impact on small business.

Drafting Information

The principal authors of these regulations are M. Grace Fleeman of the Office of Associate Chief Counsel (International) and James A. Quinn of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.643(h)–1 also issued under 26 U.S.C. 643(a)(7).

Section 1.671–2T also issued under 26 U.S.C. 643(a)(7) and 672(f)(6).

Section 1.672(f)–1 also issued under 26 U.S.C. 643(a)(7) and 672(f)(6).

Section 1.672(f)–2 also issued under 26 U.S.C. 643(a)(7) and 672(f)(3) and (6).

Section 1.672(f)–3 also issued under 26 U.S.C. 643(a)(7) and 672(f)(2) and (6).

Section 1.672(f)–4 also issued under 26 U.S.C. 643(a)(7) and 672(f)(4) and (6).

Section 1.672(f)–5 also issued under 26 U.S.C. 643(a)(7) and 672(f)(6). * * *

Par. 2. Section 1.643(h)–1 is added to read as follows:

§1.643(h)–1 Distributions by certain foreign trusts through intermediaries.

(a) *In general*—(1) *Principal purpose of tax avoidance.* Except as provided in paragraph (b) of this section, for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, and section 6048, any property (within the meaning of paragraph (f) of this section) that is transferred to a United States person by another person (an intermediary) who has received property from a foreign trust will be treated as property transferred directly by the foreign trust to the United States person if the intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of United States tax.

(2) *Principal purpose of tax avoidance deemed to exist.* For purposes of paragraph (a)(1) of this section, a transfer will be deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of United States tax if the United States person–

(i) Is related (within the meaning of paragraph (e) of this section) to a grantor of the foreign trust, or has another relationship with a grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor of the foreign trust would make a gratuitous transfer (within the meaning of §1.671–2T(e)(2)) to the United States person;

(ii) Receives from the intermediary, within the period beginning twenty-four months before and ending twenty-four months after the intermediary's receipt of property from the foreign trust, either the property the intermediary received from the foreign trust, proceeds from such property, or property in substitution for such property; and

(iii) Cannot demonstrate to the satisfaction of the Commissioner that—

(A) The intermediary has a relationship with the United States person that establishes a reasonable basis for concluding that the intermediary would make a gratuitous transfer to the United States person;

(B) The intermediary acted independently of the grantor and the trustee of the foreign trust;

(C) The intermediary is not an agent of the United States person under generally applicable United States agency principles; and

(D) The United States person timely complied with the reporting requirements of section 6039F, if applicable, if the intermediary is a foreign person.

(b) *Exceptions*—(1) *Nongratuitous transfers.* Paragraph (a) of this section does not apply to the extent that either the transfer from the foreign trust to the intermediary or the transfer from the intermediary to the United States person is a transfer that is not a gratuitous transfer within the meaning of §1.671–2T(e)(2).

(2) *Grantor as intermediary.* Paragraph (a) of this section does not apply if the intermediary is the grantor of the portion of the trust from which the property that is transferred is derived. For the definition of grantor, see §1.671–2T(e).

(c) *Effect of disregarding intermediary*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, the intermediary is treated as an agent of the foreign trust, and the property is treated as transferred to the United States person in the year the property is transferred, or made available, by the intermediary to the United States person. The fair market value of the property transferred is determined as of the date of the transfer by the intermediary to the United States person. For purposes of section 665(d)(2), the term taxes imposed on the trust includes any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the intermediary with respect to the property transferred.

(2) *Exception.* If the Commissioner determines, or if the taxpayer can demonstrate to the satisfaction of the Commissioner, that the intermediary is an agent of the United States person under generally applicable United States agency principles, the property will be treated as transferred to the United States person in the year the intermediary receives the property from the foreign trust. The fair market value of the property transferred will be determined as of the date of the transfer by the foreign trust to the intermediary. For purposes of section 901(b), any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the intermediary with respect to the property transferred will be treated as having been imposed on the United States person.

(3) *Computation of gross income of intermediary.* If property is treated as transferred directly by the foreign trust to a United States person pursuant to this section, the fair market value of such property is not taken into account in computing the gross income of the intermediary (if otherwise required to be taken into account by the intermediary but for paragraph (a) of this section).

(d) *Transfers not in excess of $10,000.* This section does not apply if, during the taxable year of the United States person, the aggregate fair market value of all property transferred to such person from all foreign trusts either directly or through one or more intermediaries does not exceed $10,000.

(e) *Related parties.* For purposes of this section, a United States person is treated as related to a grantor of a foreign trust if the United States person and the grantor are related for purposes of section 643(i)(2)(B), with the following modifications–

(1) For purposes of applying section 267 (other than section 267(f)) and section 707(b)(1), "at least 10 percent" is used instead of "more than 50 percent" each place it appears; and

(2) The principles of section 267(b)(10), using "at least 10 percent" instead of "more than 50 percent," apply to determine whether two corporations are related.

(f) *Definition of property.* For purposes of this section, the term *property* includes cash.

(g) *Examples.* The following examples illustrate the rules of this section. In each example, FT is an irrevocable foreign trust that is not treated as owned by any other person and the fair market value of the property that is transferred exceeds $10,000. The examples are as follows:

Example 1. Principal purpose of tax avoidance. FT was created in 1980 by A, a nonresident alien, for the benefit of his children and their descendants. FT's trustee, T, determines that 1000X of accumulated income should be distributed to A's granddaughter, B, who is a resident alien. Pursuant to a plan with a principal purpose of avoiding the interest charge that would be imposed by section 668, T causes FT to make a gratuitous transfer (within the meaning of §1.671–2T(e)(2)) of 1000X to I, a foreign person. I subsequently makes a gratuitous transfer of 1000X to B. Under paragraph (a)(1) of this section, FT is deemed to have made an accumulation distribution of 1000X directly to B.

Example 2. United States person unable to demonstrate that intermediary acted independently. GM and her daughter, M, are both nonresident aliens. M's daughter, D, is a resident alien. GM creates and funds FT for the benefit of her children. On July 1, 2001, FT makes a gratuitous transfer of XYZ stock to M. M immediately sells the XYZ stock and uses the proceeds to purchase ABC stock. On January 1, 2002, M makes a gratuitous transfer of the ABC stock to D. D is unable to demonstrate that M acted independently of GM and the trustee of FT in making the transfer to D. Under paragraph (a)(2) of this section, FT is deemed to have distributed the ABC stock to D. Under paragraph (c)(1) of this section, M is treated as an agent of FT, and the distribution is deemed to have been made on January 1, 2002.

Example 3. United States person demonstrates that specified conditions are satisfied. Assume the same facts as in Example 2, except that M receives 1000X cash from FT instead of XYZ stock. M gives 1000X cash to D on January 1, 2002. Also assume that M receives annual income of 5000X from her own investments and that M has given D 1000X at the beginning of each year for the past ten years. Based on this and additional information provided by D, D demonstrates to the satisfaction of the Commissioner that M has a relationship with D that establishes a reasonable basis for concluding that M would make a gratuitous transfer to D, that M acted independently of GM and the trustee of FT, that M is not an agent of D under generally applicable United States agency principles, and that D timely complied with the reporting requirements of section 6039F. FT will not be deemed under paragraph (a)(2) of this section to have made a distribution to D.

Example 4. Transfer to United States person less than 24 months before transfer to intermediary.

Several years ago, A, a nonresident alien, created and funded FT for the benefit of his children and their descendants. A has a close friend, C, who also is a nonresident alien. A's granddaughter, B, is a resident alien. On December 31, 2001, C makes a gratuitous transfer of 1000X to B. On January 15, 2002, FT makes a gratuitous transfer of 1000X to C. B is unable to demonstrate that C has a relationship with B that would establish a reasonable basis for concluding that C would make a gratuitous transfer to B or that C acted independently of A and the trustee of FT in making the transfer to B. Under paragraph (a)(2) of this section, FT is deemed to have distributed 1000X directly to B. Under paragraph (c)(1) of this section, C is treated as an agent of FT, and the distribution is deemed to have been made on December 31, 2001.

Example 5. United States person receives property in substitution for property transferred to intermediary. GM and her son, S, are both nonresident aliens. S's daughter, GD, is a resident alien. GM creates and funds FT for the benefit of her children and their descendants. On July 1, 2001, FT makes a gratuitous transfer of ABC stock with a fair market value of approximately 1000X to S. On January 1, 2002, S makes a gratuitous transfer of DEF stock with a fair market value of approximately 1000X to GD. GD is unable to demonstrate that S acted independently of GM and the trustee of FT in transferring the DEF stock to GD. Under paragraph (a)(2) of this section, FT is deemed to have distributed the DEF stock to GD. Under paragraph (c)(1) of this section, S is treated as an agent of FT, and the distribution is deemed to have been made on January 1, 2002.

Example 6. United States person receives indirect loan from foreign trust. Several years ago, A, a nonresident alien, created and funded FT for the benefit of her children and their descendants. A's daughter, B, is a resident alien. B needs funds temporarily while she is starting up her own business. If FT were to loan money directly to B, section 643(i) would apply. FT deposits 500X with FB, a foreign bank, on June 30, 2001. On July 1, 2001, FB loans 400X to B. Repayment of the loan is guaranteed by FT's 500X deposit. B is unable to demonstrate to the satisfaction of the Commissioner that FB has a relationship with B that establishes a reasonable basis for concluding that FB would make a loan to B or that FB acted independently of A and the trustee of FT in making the loan. Under paragraph (a)(2) of this section, FT is deemed to have loaned 400X directly to B on July 1, 2001. Under paragraph (c)(1) of this section, FB is treated as an agent of FT. For the treatment of loans from foreign trusts, see section 643(i).

Example 7. United States person demonstrates that specified conditions are satisfied. GM, a nonresident alien, created and funded FT for the benefit of her children and their descendants. One of GM's children is M, who is a resident alien. During the year 2001, FT makes a gratuitous transfer of 500X to M. M reports the 500X on Form 3520 as a distribution received from a foreign trust. During the year 2002, M makes a gratuitous transfer of 400X to her son, S, who also is a resident alien. M files a Form 709 treating the gratuitous transfer to S as a gift. Based on this and additional information provided by S, S demonstrates to the satisfaction of the Commissioner that M has a relationship with S that establishes a reasonable basis for concluding that M would make a gratuitous transfer to S, that M acted independently of GM and the trustee of FT, and that M is not an agent of S under generally applicable United States agency principles. FT will not be deemed under paragraph (a)(2) of this section to have made a distribution to S.

Example 8. Intermediary as agent of trust; increase in FMV. A, a nonresident alien, created and funded FT for the benefit of his children and their descendants. On December 1, 2001, FT makes a gratuitous transfer of XYZ stock with a fair market value of 85X to B, a nonresident alien. On November 1, 2002, B sells the XYZ stock to a third party in an arm's length transaction for 100X in cash. On November 1, 2002, B makes a gratuitous transfer of 98X to A's grandson, C, a resident alien. C is unable to demonstrate to the satisfaction of the Commissioner that B acted independently of A and the trustee of FT in making the transfer. Under paragraph (a)(2) of this section, FT is deemed to have made a distribution directly to C. Under paragraph (c)(1) of this section, B is treated as an agent of FT, and FT is deemed to have distributed 98X to C on November 1, 2002.

Example 9. Intermediary as agent of United States person; increase in FMV. Assume the same facts as in Example 8, except that the Commissioner determines that B is an agent of C under generally applicable United States agency principles. Under paragraph (c)(2) of this section, FT is deemed to have distributed 85X to C on December 1, 2001. C must take the gain of 15X into account in the year 2002.

Example 10. Intermediary as agent of trust; decrease in FMV. Assume the same facts as in Example 8, except that the value of the XYZ stock on November 1, 2002, is only 80X. Instead of selling the XYZ stock to a third party and transferring cash to C, B transfers the XYZ stock to C in a gratuitous transfer. Under paragraph (c)(1) of this section, FT is deemed to have distributed XYZ stock with a value of 80X to C on November 1, 2002.

Example 11. Intermediary as agent of United States person; decrease in FMV. Assume the same facts as in Example 10, except that the Commissioner determines that B is an agent of C under generally applicable United States agency principles. Under paragraph (c)(2) of this section, FT is deemed to have distributed XYZ stock with a value of 85X to C on December 1, 2001.

(h) *Effective date.* The rules of this section are applicable to transfers made to United States persons after August 10, 1999.

Par. 3. In §1.671–2, paragraph (e) is revised to read as follows:

§1.671–2 Applicable principles.

* * * * *

(e) [Reserved] For further guidance, see §1.671–2T(e).

Par. 4. Section 1.671–2T is added to read as follows:

§1.671–2T Applicable principles (temporary).

(a) through (d) [Reserved] For further guidance, see §1.671–2(a) through (d).

(e)(1) For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust. For purposes of this section, the term *property* includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. (See section 6048 for reporting requirements that apply to grantors of foreign trusts.) However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. See also §1.672(f)–5(a).

(2)(i) A gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

(ii) For purposes of this paragraph (e), a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. In addition, a person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. See, for example, section 684 regarding the recognition of gain on certain transfers to foreign trusts.

(iii) For purposes of this paragraph (e), a gratuitous transfer does not include a distribution to a trust with respect to an interest held by such trust in either a trust described in paragraph (e)(3) of this section or an entity other than a trust. For example, a distribution to a trust by a corporation with respect to its stock described in section 301 is not a gratuitous transfer.

(3) A grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in §301.7701–4(c) of this chapter, liquidating trusts described in §301.7701-4(d) of this chapter, or environmental remediation trusts described in §301.7701–4(e) of this chapter.

(4) If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, if a partnership or a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is, e.g., for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.

(5) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.

(6) The following examples illustrate the rules of this paragraph (e). Unless otherwise indicated, all trusts are domestic trusts and all other persons are United States persons. The examples are as follows:

Example 1. A creates and funds a trust, T, for the benefit of her children. B subsequently makes a gratuitous transfer to T. Under paragraph (e)(1) of this section, both A and B are grantors of T.

Example 2. A makes an investment in a fixed investment trust, T, that is classified as a trust under §301.7701–4(c)(1) of this chapter. A is a grantor of T. B subsequently acquires A's entire interest in T. Under paragraph (e)(3) of this section, B is a grantor of T with respect to such interest.

Example 3. A, an attorney, creates a foreign trust, FT, on behalf of A's client, B, and transfers $100 to FT out of A's funds. A is reimbursed by B for the $100 transferred to FT. The trust instrument states that the trustee has discretion to distribute the income or corpus of FT to B, and B's children. Both A and B are treated as grantors of FT under paragraph (e)(1) of this section. In addition, B is treated as the owner of the entire trust under section 677. Because A is reimbursed for the $100 transferred to FT on behalf of B, A is not treated as transferring any property to FT. Therefore, A is not an owner of any portion of T under sections 671 through 677 regardless of whether A retained any power over or interest in T described in sections 673 through 677. A also is not treated as an owner of any portion of T under section 679. Both A and B are responsible parties for purposes of the reporting requirements in section 6048.

Example 4. A creates and funds a trust, T. A is not treated as an owner of any portion of the trust under subpart E. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.

Example 5. A transfers cash to a trust, T, through a broker, in exchange for units in T. The units in T are not property for purposes of determining whether A has received fair market value under paragraph (e)(2)(ii) of this section. Therefore, A has made a gratuitous transfer to T, and, under paragraph (e)(1) of this section, A is a grantor of T.

Example 6. A borrows cash from T, a trust. A has not made any gratuitous transfers to T. Arm's length interest payments by A to T will not be treated as gratuitous transfers under paragraph (e)(2)(ii) of this section. Therefore, under paragraph (e)(1) of this section, A is not a grantor of T with respect to the interest payments.

Example 7. A, B's brother, creates a trust, T, for B's benefit and contributes $50,000 to T. The trustee invests the $50,000 in stock of Company X. C, B's uncle, sells property with a fair market value of $1,000,000 to T in exchange for the stock when it has appreciated to a fair market value of $100,000. Under paragraph (e)(2)(ii) of this section, the $900,000 excess value is a gratuitous transfer by C. Therefore, under paragraph (e)(1) of this section, A is a grantor with respect to the portion of the trust valued at $100,000, and C is a grantor of T with respect to the portion of the trust valued at $900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.

Example 8. G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under paragraphs (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

Example 9. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

(7) The rules of this section are applicable to any transfer to a trust, or transfer of an interest in a trust, on or after August 10, 1999. In accordance with section 7805(e)(2), the rules of this section will expire before August 12, 2002.

Par. 5. Sections 1.672(f)–1, 1.672(f)–2, 1.672(f)–3, 1.672(f)–4, and 1.672(f)–5 are added to read as follows:

§1.672(f)–1 Foreign persons not treated as owners.

(a) *General rule*—(1) *Application of the general rule.* Section 672(f)(1) provides that subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code (the grantor trust rules) shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through one or more entities) in computing the income of a citizen or resident of the United States or a domestic corporation. Accordingly, the grantor trust rules apply to the extent that any portion of the trust, upon application of the grantor trust rules without regard to section 672(f), is treated as owned by a United States citizen or resident or domestic corporation. The grantor trust rules do not apply to any portion of the trust to the extent that, upon application of the grantor trust rules without regard to section 672(f), that portion is treated as owned by a person other than a United States citizen or resident or domestic corporation, unless the person is described in §1.672(f)–2(a) (relating to certain foreign corporations treated as domestic corporations), or one of the exceptions set forth in §1.672(f)–3 is met, (relating to: trusts where the grantor can revest trust assets; trusts where the only amounts distributable are to the grantor or the grantor's spouse; and compensatory trusts). Section 672(f) applies to domestic and foreign trusts. Any portion of the trust that is not treated as owned by a grantor or another person is subject to the rules of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(2) *Determination of portion based on application of the grantor trust rules.* The determination of the portion of a trust treated as owned by the grantor or other person is to be made based on the terms of the trust and the application of the grantor trust rules and section 671 and the regulations thereunder.

(b) *Example.* The following example illustrates the rules of this section:

Example. (i) A, a nonresident alien, funds an irrevocable domestic trust, DT, for the benefit of his son, B, who is a United States citizen, with stock of Corporation X. A's brother, C, who also is a United States citizen, contributes stock of Corporation Y to the trust for the benefit of B. A has a reversionary interest within the meaning of section 673 in the X stock that would cause A to be treated as the owner of the X stock upon application of the grantor trust rules without regard to section 672(f). C has a reversionary interest within the meaning of section 673 in the Y stock that would cause C to be treated as the owner of the Y stock upon application of the grantor trust rules without regard to section 672(f). The trustee has discretion to accumulate or currently distribute income of DT to B.

(ii) Because A is a nonresident alien, application of the grantor trust rules without regard to section 672(f) would not result in the portion of the trust consisting of the X stock being treated as owned by a United States citizen or resident. None of the exceptions in §1.672(f)–3 applies because A cannot revest the X stock in A, amounts may be distributed during A's lifetime to B, who is neither a grantor nor a spouse of a grantor, and the trust is not a compensatory trust. Therefore, pursuant to paragraph (a)(1) of this section, A is not treated as an owner under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code, of the portion of the trust consisting of the X stock. Any distributions from such portion of the trust are subject to the rules of subparts A through D (641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(iii) Because C is a United States citizen, paragraph (a)(1) of this section does not prevent C from being treated under section 673 as the owner of the portion of the trust consisting of the Y stock.

(c) *Effective date.* The rules of this section are applicable to taxable years of a trust beginning after August 10, 1999.

§1.672(f)–2 Certain foreign corporations.

(a) *Application of general rule.* Subject to the provisions of paragraph (b) of this section, if the owner of any portion of a trust upon application of the grantor trust rules without regard to section 672(f) is a controlled foreign corporation (as defined in section 957), a passive foreign investment company (as defined in section 1297), or a foreign personal holding company (as defined in section 552), the corporation will be treated as a domestic corporation for purposes of applying the rules of §1.672(f)–1.

(b) *Gratuitous transfers to United States persons*—(1) *Transfer from trust to which corporation made a gratuitous transfer.* If a trust (or portion of a trust) to which a controlled foreign corporation, passive foreign investment company, or foreign personal holding company has made a gratuitous transfer (within the meaning of §1.671–2T(e)(2)), makes a gratuitous transfer to a United States person, the controlled foreign corporation, passive foreign investment company, or foreign personal holding company, as the case may be, is treated as a foreign corporation for purposes of §1.672(f)–4(c), relating to gratuitous transfers from trusts (or portions of trusts) to which a partnership or foreign corporation has made a gratuitous transfer.

(2) *Transfer from trust over which corporation has a section 678 power.* If a trust (or portion of a trust) that a controlled foreign corporation, passive foreign investment company, or foreign personal holding company is treated as owning under section 678 makes a gratuitous transfer to a United States person, the controlled foreign corporation, passive foreign investment company, or foreign personal holding company, as the case may be, is treated as a foreign corporation that had made a gratuitous transfer to the trust (or portion of a trust) and the rules of §1.672(f)–4(c) apply.

(c) *Special rules for passive foreign investment companies*—(1) *Application of section 1297.* For purposes of determining whether a foreign corporation is a passive foreign investment company as defined in section 1297, the grantor trust rules apply as if section 672(f) had not come into effect.

(2) *References to renumbered Internal Revenue Code section.* For taxable years of shareholders beginning on or before December 31, 1997, and taxable years of passive foreign investment companies ending with or within such taxable years of the shareholders, all references in this §1.672(f)–2 to section 1297 are deemed to be references to section 1296.

(d) *Examples.* The following examples illustrate the rules of this section. In each example, FT is an irrevocable foreign trust, and CFC is a controlled foreign corporation. The examples are as follows:

Example 1. Application of general rule. CFC creates and funds FT. CFC is the grantor of FT within the meaning of §1.671–2T(e). CFC has a reversionary interest in FT within the meaning of section 673 that would cause CFC to be treated as the owner of FT upon application of the grantor trust rules without regard to section 672(f). Under paragraph (a) of this section, CFC is treated as a domestic corporation for purposes of applying the general rule of §1.672(f)–1. Thus, §1.672(f)–1 does not prevent CFC from being treated as the owner of FT under section 673.

Example 2. Distribution from trust to which CFC made gratuitous transfer. A, a nonresident alien, owns 40 percent of the stock of CFC. A's brother B, a resident alien, owns the other 60 percent of the stock of CFC. CFC makes a gratuitous transfer to FT. FT makes a gratuitous transfer to A's daughter, C, who is a resident alien. Under paragraph (b)(1) of this section, CFC will be treated as a foreign corporation for purposes of §1.672(f)–4(c). For further guidance, see §1.672(f)–4(g) *Example 2* through *Example 4*.

(e) *Effective date.* The rules of this section are generally applicable to taxable years of shareholders of controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies beginning after August 10, 1999, and taxable years of controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies ending with or within such taxable years of the shareholders.

§1.672(f)–3 Exceptions to general rule.

(a) *Certain revocable trusts*—(1) *In general.* Subject to the provisions of paragraph (a)(2) of this section, the general rule of §1.672(f)–1 does not apply to any portion of a trust for a taxable year of the trust if the power to revest absolutely in the grantor title to such portion is exercisable solely by the grantor (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf) without the approval or consent of any other person. If the grantor can exercise such power only with the approval of a related or subordinate party who is subservient to the grantor, such power is treated as exercisable solely by the grantor. For the definition of *grantor*, see §1.671–2T(e). For the definition of *related or subordinate party*, see §1.672(c)–1. For purposes of this paragraph (a), a related or subordinate party is subservient to the grantor unless the presumption in the last sentence of §1.672(c)–1 is rebutted by a preponderance of the evidence. A trust (or portion of a trust) that fails to qualify for the exception provided by this paragraph (a) for a particular taxable year of the trust will be subject to the general rule of §1.672(f)–1 for that taxable year and all subsequent taxable years of the trust.

(2) *183-day rule.* For purposes of paragraph (a)(1) of this section, the grantor is treated as having a power to revest for a taxable year of the trust only if the grantor has such power for a total of 183 or more days during the taxable year of the trust. If the first or last taxable year of the trust (including the year of the grantor's death) is less than 183 days, the grantor is treated as having a power to revest for purposes of paragraph (a)(1) of this section if the grantor has such power for each day of the first or last taxable year, as the case may be.

(3) *Grandfather rule for certain revocable trusts in existence on September 19, 1995.* Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of §1.672(f)–1 does not apply to any portion of a trust that was treated as owned by the grantor under section 676 on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995.

(4) *Examples.* The following examples illustrate the rules of this paragraph (a):

Example 1. Grantor is owner. FP1, a foreign person, creates and funds a revocable trust, T, for the benefit of FP1's children, who are resident aliens. The trustee is a foreign bank, FB, that is owned and controlled by FP1 and FP2, who is FP1's brother. The power to revoke T and revest absolutely in FP1 title to the trust property is exercisable by FP1, but only with the approval or consent of FB. The trust instrument contains no standard that FB must apply in determining whether to approve or consent to the revocation of T. There are no facts that would suggest that FB is not subservient to FP1. Therefore, the exception in paragraph (a)(1) of this section is applicable.

Example 2. Death of grantor. Assume the same facts as in Example 1, except that FP1 dies. After FP1's death, FP2 has the power to withdraw the assets of T, but only with the approval of FB. There are no facts that would suggest that FB is not subservient to FP2. However, the exception in paragraph (a)(1) of this section is no longer applicable, because FP2 is not a grantor of T within the meaning of §1.671–2T(e).

Example 3. Trustee is not related or subordinate party. Assume the same facts as in Example 1, except that neither FP1 nor any member of FP1's family has any substantial ownership interest or other connection with FB. FP1 can remove and replace FB at any time for any reason. Although FP1 can replace FB with a related or subordinate party if FB refuses to approve or consent to FP1's decision to revest the trust property in himself, FB is not a related or subordinate party. Therefore, the exception in paragraph (a)(1) of this section is not applicable.

Example 4. Unrelated trustee will consent to revocation. FP, a foreign person, creates and funds an irrevocable trust, T. The trustee is a foreign bank, FB, that is not a related or subordinate party within the meaning of §1.672(c)-1. FB has the discretion to distribute trust income or corpus to beneficiaries of T, including FP. Even if FB would in fact distribute all the trust property to FP if requested to do so by FP, the exception in paragraph (a)(1) of this section is not applicable, because FP does not have the power to revoke T.

(b) *Certain trusts that can distribute only to the grantor or the spouse of the grantor*—(1) *In general.* The general rule of §1.672(f)–1 does not apply to any trust (or portion of a trust) if at all times during the lifetime of the grantor the only amounts distributable (whether income or corpus) from such trust (or portion thereof) are amounts distributable to the grantor or the spouse of the grantor. For purposes of this paragraph (b), payments of amounts that are not gratuitous transfers (within the meaning of §1.671–2T(e)(2)) are not amounts distributable. For the definition of grantor, see §1.671–2T(e).

(2) *Amounts distributable in discharge of legal obligations*—(i) *In general.* A trust (or portion of a trust) does not fail to satisfy paragraph (b)(1) of this section solely because amounts are distributable from the trust (or portion thereof) in discharge of a legal obligation of the grantor or the spouse of the grantor. Subject to the provisions of paragraph (b)(2)(ii) of this section, an obligation is considered a legal obligation for purposes of this paragraph (b)(2)(i) if it is enforceable under the local law of the jurisdiction in which the grantor (or the spouse of the grantor) resides.

(ii) *Related parties*—(A) *In general.* Except as provided in paragraph (b)(2)-(ii)(B) of this section, an obligation to a person who is a related person for purposes of §1.643(h)–1(e) (other than an individual who is legally separated from the grantor under a decree of divorce or of separate maintenance) is not a legal obligation for purposes of paragraph (b)(2)(i) of this section unless it was contracted bona fide and for adequate and full consideration in money or money's worth (see §20.2043–1 of this chapter).

(B) *Exceptions*—(*1*) *Amounts distributable in support of certain individuals.* Paragraph (b)(2)(ii)(A) of this section does not apply with respect to amounts that are distributable from the trust (or portion thereof) to support an individual who—

(*i*) Would be treated as a dependent of the grantor or the spouse of the grantor under section 152(a)(1) through (9), without regard to the requirement that over half of the individual's support be received from the grantor or the spouse of the grantor; and

(*ii*) Is either permanently and totally disabled (within the meaning of section 22(e)(3)), or less than 19 years old.

(*2*) *Certain potential support obligations.* The fact that amounts might become distributable from a trust (or portion of a trust) in discharge of a potential obligation under local law to support an individual other than an individual described in paragraph (b)(2)(ii)(B)(*1*) of this section is disregarded if such potential obligation is not reasonably expected to arise under the facts and circumstances.

(*3*) *Reinsurance trusts.* [Reserved]

(3) *Grandfather rule for certain section 677 trusts in existence on September 19, 1995.* Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of §1.672(f)–1 does not apply to any portion of a trust that was treated as owned by the grantor under section 677 (other than section 677(a)(3)) on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995.

(4) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. Amounts distributable only to grantor or grantor's spouse. H and his wife, W, are both nonresident aliens. H is 70 years old, and W is 65. H and W have a 30-year-old child, C, a resident alien. There is no reasonable expectation that H or W will ever have an obligation under local law to support C or any other individual. H creates and funds an irrevocable trust, FT, using only his separate property. H is the grantor of FT within the meaning of §1.671–2T(e). Under the terms of FT, the only amounts distributable (whether income or corpus) from FT as long as either H or W is alive are amounts distributable to H or W. Upon the death of both H and W, C may receive distributions from FT. During H's lifetime, the exception in paragraph (b)(1) of this section is applicable.

Example 2. Effect of grantor's death. Assume the same facts as in *Example 1.* H predeceases W. Assume that W would be treated as owning FT under section 678 if the grantor trust rules were applied without regard to section 672(f). The exception in paragraph (b)(1) of this section is no longer applicable, because W is not a grantor of FT within the meaning of §1.671–2T(e).

Example 3. Amounts temporarily distributable to person other than grantor or grantor's spouse. Assume the same facts as in *Example 1,* except that C (age 30) is a law student at the time FT is created and the trust instrument provides that, as long as C is in law school, amounts may be distributed from FT to pay C's expenses. Thereafter, the only amounts distributable from FT as long as either H or W is alive will be amounts distributable to H or W. Even assuming there is an enforceable obligation under local law for H and W to support C while he is in school, distributions from FT in payment of C's expenses cannot qualify as distributions in discharge of a legal obligation under paragraph (b)(2) of this section, because C is neither permanently and totally disabled nor less than 19 years old. The exception in paragraph (b)(1) of this section is not applicable. After C graduates from law school, the exception in paragraph (b)(1) still will not be applicable, because amounts were distributable to C during the lifetime of H.

Example 4. Fixed investment trust. FC, a foreign corporation, invests in a domestic fixed investment trust, DT, that is classified as a trust under §301.7701–4(c)(1) of this chapter. Under the terms of DT, the only amounts that are distributable from FC's portion of DT are amounts distributable to FC. The exception in paragraph (b)(1) of this section is applicable to FC's portion of DT.

Example 5. Reinsurance trust. A domestic insurance company, DI, reinsures a portion of its business with an unrelated foreign insurance company, FI. To satisfy state regulatory requirements, FI places the premiums in an irrevocable domestic trust, DT. The trust funds are held by a United States bank and may be used only to pay claims arising out of the reinsurance policies, which are legally enforceable under the local law of the jurisdiction in which FI resides. On the termination of DT, any assets remaining will revert to FI. Because the only amounts that are distributable from DT are distributable either to FI or in discharge of FI's legal obligations within the meaning of paragraph (b)(2)(i) of this section, the exception in paragraph (b)(1) of this section is applicable.

Example 6. Trust that provides security for loan. FC, a foreign corporation, borrows money from B, an unrelated bank, to finance the purchase of an airplane. FC creates a foreign trust, FT, to hold the airplane as security for the loan from B. The only amounts that are distributable from FT while the loan is outstanding are amounts distributable to B in the event that FC defaults on its loan from B. When FC repays the loan, the trust assets will revert to FC. The loan is a legal obligation of FC within the meaning of paragraph (b)(2)(i) of this section, because it is enforceable under the local law of the country in which FC is incorporated. Paragraph (b)(2)(ii) of this section is not applicable, because B is not a related person for purposes of §1.643(h)–1(e). The exception in paragraph (b)(1) of this section is applicable.

(c) *Compensatory trusts*—(1) *In general.* The general rule of §1.672(f)–1 does not apply to any portion of—

(i) A nonexempt employees' trust described in section 402(b), including a trust created on behalf of a self-employed individual;

(ii) A trust, including a trust created on behalf of a self-employed individual, that would be a nonexempt employees' trust described in section 402(b) but for the fact that the trust's assets are not set aside from the claims of creditors of the actual or deemed transferor within the meaning of §1.83–3(e); and

(iii) Any additional category of trust that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(2) *Exceptions.* The Commissioner may, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), designate categories of compensatory trusts to which the general rule of paragraph (c)(1) of this section does not apply.

(d) *Separate accounting for gratuitous transfers to grandfathered trusts after September 19, 1995.* If a trust that was treated as owned by the grantor under section 676 or 677 (other than section 677(a)(3)) on September 19, 1995, contains both amounts held in the trust on September 19, 1995, and amounts that were gratuitously transferred to the trust after September 19, 1995, paragraphs (a)(3) and (b)(3) of this section apply only if the amounts that were gratuitously transferred to the trust after September 19, 1995, are treated as a separate portion of the trust that is accounted for under the rules of §1.671–3(a)(2). If the amounts that were gratuitously transferred to the trust after September 19, 1995 are not so accounted for, the general rule of §1.672(f)–1 applies to the entire trust. If such amounts are so accounted for, and without regard to whether there is physical separation of the assets, the general rule of §1.672(f)–1 does not apply to the portion of the trust that is attributable to amounts that were held in the trust on September 19, 1995.

(e) *Effective date.* The rules of this section are generally applicable to taxable years of a trust beginning after August 10, 1999. The initial separate accounting required by paragraph (d) of this section must be prepared by the due date (including extensions) for the tax return of the trust for the first taxable year of the trust beginning after August 10, 1999.

§1.672(f)–4 Recharacterization of purported gifts.

(a) *In general*—(1) *Purported gifts from partnerships.* Except as provided in paragraphs (b), (e), and (f) of this section, and without regard to the existence of any trust, if a United States person (United States donee) directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from a partnership, the purported gift or bequest must be included in the United States donee's gross income as ordinary income.

(2) *Purported gifts from foreign corporations.* Except as provided in paragraphs (b), (e), and (f) of this section, and without regard to the existence of any trust, if a United States donee directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from any foreign corporation, the purported gift or bequest must be included in the United States donee's gross income as if it were a distribution from the foreign corporation. If the foreign corporation is a passive foreign investment company (within the meaning of section 1297), the rules of section 1291 apply. For purposes of section 1012, the United States donee is not treated as having basis in the stock of the foreign corporation. However, for purposes of section 1223, the United States donee is treated as having a holding period in the stock of the foreign corporation on the date of the deemed distribution equal to the weighted average of the holding periods of the actual interest holders (other than any interest holders who treat the portion of the purported gift attributable to their interest in the foreign corporation in the manner described in paragraph (b)(1) of this section). For purposes of section 902, a United States donee that is a domestic corporation is not treated as owning any voting stock of the foreign corporation.

(b) *Exceptions*—(1) *Partner or shareholder treats transfer as distribution and gift.* Paragraph (a) of this section does not apply to the extent the United States donee can demonstrate to the satisfaction of the Commissioner that either—

(i) A United States citizen or resident alien individual who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for United States tax purposes as a distribution to such individual and a subsequent gift or bequest to the United States donee; or

(ii) A nonresident alien individual who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for purposes of the tax laws of the nonresident alien individual's country of residence as a distribution to such individual and a subsequent gift or bequest to the United States donee, and the United States donee timely complied with the reporting requirements of section 6039F, if applicable.

(2) *All beneficial owners of domestic partnership are United States citizens or residents or domestic corporations.* Paragraph (a)(1) of this section does not apply to a purported gift or bequest from a domestic partnership if the United States donee can demonstrate to the satisfaction of the Commissioner that all beneficial owners (within the meaning of §1.1441–1(c)(6)) of the partnership are United States citizens or residents or domestic corporations.

(3) *Contribution to capital of corporate United States donee.* Paragraph (a) of this section does not apply to the extent a United States donee that is a corporation can establish that the purported gift or bequest was treated for United States tax purposes as a contribution to the capital of the United States donee to which section 118 applies.

(4) *Charitable transfers.* Paragraph (a) of this section does not apply if either—

(i) The United States donee is described in section 170(c); or

(ii) The transferor has received a ruling or determination letter, which has been neither revoked nor modified, from the Internal Revenue Service recognizing its exempt status under section 501(c)(3), and the transferor made the transfer pursuant to an exempt purpose for which the transferor was created or organized. For purposes of the preceding sentence, a ruling or determination letter recognizing exemption may not be relied upon if there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of the organization.

(c) *Certain transfers from trusts to which a partnership or foreign corporation has made a gratuitous transfer*—(1) *Generally treated as distribution from partnership or foreign corporation.* Except as provided in paragraphs (c)(2) and (3) of this section, if a United States donee receives a gratuitous transfer (within the meaning of §1.671–2T(e)(2)) from a trust (or portion of a trust) to which a partnership or foreign corporation has made a gratuitous transfer, the United States donee must treat the transfer as a purported gift or bequest from the partnership or foreign corporation that is subject to the rules of paragraph (a) of this section (including the exceptions in paragraphs (b) and (f) of this section). This paragraph (c) applies without regard to who is treated as the grantor of the trust (or portion thereof) under §1.671–2T(e)(4).

(2) *Alternative rule.* Except as provided in paragraph (c)(3) of this section, if the United States tax computed under the rules of paragraphs (a) and (c)(1) of this section does not exceed the United States tax that would be due if the United States donee treated the transfer as a distribution from the trust (or portion thereof), paragraph (c)(1) of this section does not apply and the United States donee must treat the transfer as a distribution from the trust (or portion thereof) that is subject to the rules of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. For purposes of paragraph (f) of this section, the transfer is treated as a purported gift or bequest from the partnership or foreign corporation that made the gratuitous transfer to the trust (or portion thereof).

(3) *Exception.* Neither paragraph (c)(1) of this section nor paragraph (c)(2) of this section applies to the extent the United States donee can demonstrate to the satisfaction of the Commissioner that the transfer represents an amount that is, or has been, taken into account for United States tax purposes by a United States citizen or resident or a domestic corporation. A transfer will be deemed to be made first out of amounts that have not been taken into account for United States tax purposes by a United States citizen or resident or a domestic corporation, unless the United States donee can demonstrate to the satisfaction of the Commissioner that another ordering rule is more appropriate.

(d) *Definition of purported gift or bequest*—(1) *In general.* Subject to the provisions of paragraphs (d)(2) and (3) of this section, *a purported gift or bequest* for purposes of this section is any transfer of property by a partnership or foreign corporation other than a transfer for fair market value (within the meaning of §1.671–2T(e)(2)(ii)) to a person who is not a partner in the partnership or a shareholder of the foreign corporation (or to a person who is a partner in the partnership or a shareholder of a foreign corporation, if the amount transferred is inconsistent with the partner's interest in the partnership or the shareholder's interest in the corporation, as the case may be). For purposes of this section, the term *property* includes cash.

(2) *Transfers for less than fair market value*—(i) *Excess treated as purported gift or bequest.* Except as provided in paragraph (d)(2)(ii) of this section, if a transfer described in paragraph (d)(1) of this section is for less than fair market value, the excess of the fair market value of the property transferred over the value of the property received, services rendered, or the right to use property is treated as a purported gift or bequest.

(ii) *Exception for transfers to unrelated parties.* No portion of a transfer described in paragraph (d)(1) of this section will be treated as a purported gift or bequest for purposes of this section if the United States donee can demonstrate to the satisfaction of the Commissioner that the United States donee is not related to a partner or shareholder of the transferor within the meaning of §1.643(h)–1(e) or does not have another relationship with a partner or shareholder of the transferor that establishes a reasonable basis for concluding that the transferor would make a gratuitous transfer to the United States donee.

(e) *Prohibition against affirmative use of recharacterization by taxpayers.* A taxpayer may not use the rules of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Internal Revenue Code. Thus, with respect to such taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue Code) the transfer in accordance with its form or its economic substance.

(f) *Transfers not in excess of $10,000.* This section does not apply if, during the taxable year of the United States donee, the aggregate amount of purported gifts or bequests that is transferred to such United States donee directly or indirectly from all partnerships or foreign corporations that are related (within the meaning of section 643(i)) does not exceed $10,000. The aggregate amount must include gifts or bequests from persons that the United States donee knows or has reason to know are related to the partnership or foreign corporation (within the meaning of section 643(i)).

(g) *Examples.* The following examples illustrate the rules of this section. In each example, the amount that is transferred exceeds $10,000. The examples are as follows:

Example 1. Distribution from foreign corporation. FC is a foreign corporation that is wholly owned by A, a nonresident alien who is resident in Country C. FC makes a gratuitous transfer of property directly to A's daughter, B, who is a resident alien. Under paragraph (a)(2) of this section, B generally must treat the transfer as a dividend from FC to the extent of FC's earnings and profits and as an amount received in excess of basis thereafter. If FC is a passive foreign investment company, B must treat the amount received as a distribution under section 1291. B will be treated as having the same holding period as A. However, under paragraph (b)(1)(ii) of this section, if B can establish to the satisfaction of the Commissioner that, for purposes of the tax laws of Country C, A treated (and reported, if applicable) the transfer as a distribution to himself and a subsequent gift to B, B may treat the transfer as a gift (provided B timely complied with the reporting requirements of section 6039F, if applicable).

Example 2. Distribution of corpus from trust to which foreign corporation made gratuitous transfer. FC is a foreign corporation that is wholly owned by A, a nonresident alien who is resident in Country C. FC makes a gratuitous transfer to a foreign trust, FT, that has no other assets. FT immediately makes a gratuitous transfer in the same amount to A's daughter, B, who is a resident alien. Under paragraph (c)(1) of this section, B must treat the transfer as a transfer from FC that is subject to the rules of paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, B must treat the transfer as a dividend from FC unless she can establish to the satisfaction of the Commissioner that, for purposes of the tax laws of Country C, A treated (and reported, if applicable) the transfer as a distribution to himself and a subsequent gift to B and that B timely complied with the reporting requirements of section 6039F, if applicable. The alternative rule in paragraph (c)(2) of this section would not apply as long as the United States tax computed under the rules of paragraph (a)(2) of this section is equal to or greater than the United States tax that would be due if the transfer were treated as a distribution from FT.

Example 3. Accumulation distribution from trust to which foreign corporation made gratuitous transfer. FC is a foreign corporation that is wholly owned by A, a nonresident alien. FC is not a passive foreign investment company (as defined in section 1297). FC makes a gratuitous transfer of 100X to a foreign trust, FT, on January 1, 2001. FT has no other assets on January 1, 2001. Several years later, FT makes a gratuitous transfer of 1000X to A's daughter, B, who is a United States resident. Assume that the section 668 interest charge on accumulation distributions will apply if the transfer is treated as a distribution from FT. Under the alternative rule of paragraph (c)(2) of this section, B must treat the transfer as an accumulation distribution from FT, because the resulting United States tax liability is greater than the United States tax that would be due if the transfer were treated as a transfer from FC that is subject to the rules of paragraph (a) of this section.

Example 4. Transfer from trust that is treated as owned by United States citizen. Assume the same facts as in Example 3, except that A is a United States citizen. Assume that A treats and reports the transfer to FT as a constructive distribution to himself, followed by a gratuitous transfer to FT, and that A is properly treated as the grantor of FT within the meaning of §1.671–2T(e). A is treated as the owner of FT under section 679 and, as required by section 671 and the regulations thereunder, A includes all of FT's items of income, deductions, and credit in computing his taxable income and credits. Neither paragraph (c)(1) nor paragraph (c)(2) of this section is applicable, because the exception in paragraph (c)(3) of this section applies.

Example 5. Transfer for less than fair market value. FC is a foreign corporation that is wholly owned by A, a nonresident alien. On January 15, 2001, FC transfers property directly to A's daughter, B, a resident alien, in exchange for 90X. The Commissioner later determines that the fair market value of the property at the time of the transfer was 100X. Under paragraph (d)(2)(i) of this section, 10X will be treated as a purported gift to B on January 15, 2001.

(h) *Effective date.* The rules of this section are generally applicable to any transfer after August 10, 1999, by a partnership or foreign corporation, or by a trust to which a partnership or foreign corporation makes a gratuitous transfer after August 10, 1999.

§1.672(f)–5 Special rules.

(a) *Transfers by certain beneficiaries to foreign grantor*—(1) *In general.* If, but for section 672(f)(5), a foreign person would be treated as the owner of any portion of a trust, any United States beneficiary of the trust is treated as the grantor of a portion of the trust to the extent the United States beneficiary directly or indirectly made transfers of property to such foreign person (without regard to whether the United States beneficiary was a United States beneficiary at the time of any transfer) in excess of transfers to the United States beneficiary from the foreign person. The rule of this paragraph (a) does not apply to the extent the United States beneficiary can demonstrate to the satisfaction of the Commissioner that the transfer by the United States beneficiary to the foreign person was wholly unrelated to any transaction involving the trust. For purposes of this paragraph (a), the term property includes cash, and a transfer of property does not include a transfer that is not a gratuitous transfer (within the meaning of §1.671-2T(e)(2)). In addition, a gift is not taken into account to the extent such gift would not be characterized as a taxable gift under section 2503(b). For a definition of United States beneficiary, see section 679.

(2) *Examples.* The following examples illustrate the rules of this section:

Example 1. A, a nonresident alien, contributes property to FC, a foreign corporation that is wholly owned by A. FC creates a foreign trust, FT, for the benefit of A and A's children. FT is revocable by FC without the approval or consent of any other person. FC funds FT with the property received from A. A and A's family move to the United States. Under paragraph (a)(1) of this section, A is treated as a grantor of FT. (A may also be treated as an owner of FT under section 679(a)(4).)

Example 2. B, a United States citizen, makes a gratuitous transfer of $1 million to B's uncle, C, a nonresident alien. C creates a foreign trust, FT, for the benefit of B and B's children. FT is revocable by C without the approval or consent of any other person. C funds FT with the property received from B. Under paragraph (a)(1) of this section, B is treated as a grantor of FT. (B also would be treated as an owner of FT as a result of section 679.)

(b) *Entity characterization.* Entities generally are characterized under United States tax principles for purposes of §§1.672(f)–1 through 1.672(f)–5. See §§301.7701–1 through 301.7701–4 of this chapter. However, solely for purposes of §1.672(f)–4, a transferor that is a wholly owned business entity is treated as a corporation, separate from its single owner.

(c) *Effective date.* The rules in paragraph (a) of this section are applicable to transfers to trusts on or after August 10, 1999. The rules in paragraph (b) of this section areapplicable August 10, 1999.

John M. Dalrymple,
Acting Deputy Commissioner of Internal Revenue.

Approved July 23, 1999.

Donald C. Lubick,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 5, 1999, 2:09 p.m., and published in the issue of the Federal Register for August 10, 1999, 64 F.R. 43267)

Section 809.—Reduction in Certain Deductions of Mutual Life Insurance Companies

26 CFR 1.809–9: Computation of the differential earnings rate and the recomputed differential earnings rate.

Mutual life insurance companies; differential earnings rate. The differential earnings rate for 1998 and the recomputed differential earnings rate for 1997 are set forth for use by mutual life insurance companies to compute their income tax liabilities for 1998.

Rev. Rul. 99–35

This revenue ruling contains the differential earnings rate for 1998 and the recomputed differential earnings rate for 1997. Under § 809 of the Internal Revenue Code, mutual life insurance companies use these rates in computing their Federal income tax liability for taxable years beginning in 1998. This revenue ruling also contains the figures on which the determinations of these rates are based. Notice 99–13, 1999–10 I.R.B. 26, contained tentative determinations of these rates.

Section 809(a) provides that, in the case of any mutual life insurance company, the amount of the deduction allowable under § 808 for policyholder dividends is reduced (but not below zero) by the "differential earnings amount." Any excess of the differential earnings amount over the amount of the deduction allowable under § 808 is taken into account as a reduction in the closing balance of reserves under subsections (a) and (b) of § 807. The "differential earnings amount" for any taxable year is the amount equal to the product of (a) the life insurance company's average equity base for the taxable year multiplied by (b) the "differential earnings rate" for that taxable year. The "differential earnings rate" for the taxable year is the excess of (a) the "imputed earnings rate" for the taxable year over (b) the "average mutual earnings rate" for the second calendar year preceding the calendar year in which the taxable year begins. The "imputed earnings rate" for any taxable year is the amount that bears the same ratio to 16.5 percent as the "current stock earnings rate" for the taxable year bears to the "base period stock earnings rate."

Section 809(f) provides that, in the case of any mutual life insurance company, if the "recomputed differential earnings amount" for any taxable year exceeds the differential earnings amount for that taxable year, the excess is included in life insurance gross income for the succeeding taxable year. If the differential earnings amount for any taxable year exceeds the recomputed differential earnings amount for that taxable year, the excess is allowed as a life insurance deduction for the succeeding taxable year. The "recomputed differential earnings amount" for any taxable year is an amount calculated in the same manner as the differential earnings amount for that taxable year, except that the average mutual earnings rate for the calendar year in which the taxable year begins is substituted for the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.

The stock earnings rates and mutual earnings rates taken into account under § 809 generally are determined by dividing statement gain from operations by the average equity base. For this purpose, the term "statement gain from operations" means "the net gain or loss from operations required to be set forth in the annual statement, determined without regard to Federal income taxes, and . . . properly adjusted for realized capital gains and losses. . . ." *See* § 809(g)(1). The term "equity base" is defined as an amount determined in the manner prescribed by regulations equal to surplus and capital increased by the amount of nonadmitted financial assets, the excess of the amount of statutory reserves over the amount of tax reserves, the sum of certain other reserves, and 50 percent of any policyholder dividends (or other similar liability) payable in the following taxable year. *See* § 809(b)(2), (3), (4), (5) and (6). Section 1.809–10 of the Income Tax Regulations provides that the equity base includes both the asset valuation reserve and the interest maintenance reserve for taxable years ending after December 31, 1991.

Section 1.809–9(a) of the regulations provides that neither the differential earnings rate under § 809(c) nor the recomputed differential earnings rate that is used in computing the recomputed differential earnings amount under § 809(f)(3) may be less than zero.

Rev. Rul. 99–3, 1999–3 I.R.B. 4, provides that a life insurance subsidiary of a mutual holding company is not a mutual life insurance company for which the deduction for policyholder dividends is reduced pursuant to §§ 808(c)(2) and 809.

For purposes of § 809, the differential earnings rate for 1998 and the rate used to calculate the recomputed differential earnings amount for 1997 (the recomputed differential earnings rate for 1997), and the figures on which these two rates are based are set forth in Table 1.

Rev. Rul. 99–35 Table 1

Determination of Rates To Be Used For Taxable Years Beginning in 1998

Differential earnings rate for 1998	0.081
Recomputed differential earnings rate for 1997	0
Imputed earnings rate for 1997	13.813
Imputed earnings rate for 1998	16.193
Base period stock earnings rate	18.221
Current stock earnings rate for 1998	17.882
Stock earnings rate for 1995	17.087
Stock earnings rate for 1996	17.238
Stock earnings rate for 1997	19.321
Average mutual earnings rate for 1996	16.112
Average mutual earnings rate for 1997	15.566

DRAFTING INFORMATION

The principal author of this revenue ruling is Katherine A. Hossofsky of the Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Ms. Hossofsky on (202) 622-3477 (not a toll-free number).

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.202: Closing Agreements.

Rev. Proc. 99–31

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SECTION 1. PURPOSE AND BACKGROUND

.01 *Purpose.* (1) This revenue procedure augments the Employee Plans Compliance Resolution System ("EPCRS"). It describes and illustrates many of the correction methods sponsors of qualified plans under Internal Revenue Code § 401(a) or 403(a) can use to correct failures to comply with the qualified plan rules. Among the numerous favorable comments on EPCRS, many suggested that it would be helpful to provide additional guidance on acceptable means of correction.

(2) This revenue procedure, together with the standardized correction methods described in Rev. Proc. 98–22, 1998–12 I.R.B. 11, gives plan sponsors methods (and in many cases alternative methods) they can use to correct the Operational Failures typically encountered under EPCRS. Of course, other methods of correcting the same Operational Failures might also be reasonable and appropriate. The methods described in this revenue procedure will be particularly useful for plan sponsors self-correcting Operational Failures under APRSC. The revenue procedure includes numerous examples illustrating these correction methods.

(3) The correction methods described in this revenue procedure include the following —

- For § 401(k) and § 401(m) nondiscrimination failures, in addition to the SVP correction method, a "one-to-one" correction method which combines distribution of excess contributions with an equivalent corrective contribution that typically will be less than the corrective contribution under the SVP correction method for the same failure;
- If eligible employees have been excluded from receiving employer contributions under a profit-sharing or stock bonus plan, then, in addition to the SVP correction method, improperly allocated contributions can be reallocated to the excluded eligible employees, in accordance with specified requirements;
- If an amount has been improperly forfeited under a defined contribution plan, then either a corrective contribution can be made or, in accordance with specified requirements, the improperly forfeited amount can be reallocated;
- If payments from a defined benefit plan exceeded the § 415(b) limits, the excess can be repaid to the plan or future payments can be reduced;
- If annual additions under a defined contribution plan exceeded the § 415(c) limits, then in addition to the SVP correction method, the previously paid excess can be repaid to the plan or, in the case of certain terminated employees who have received a distribution of elective deferrals, nonvested employer contributions can be forfeited;
- If amounts in excess of certain other limits have been paid, then the excesses can be repaid to the plan or, as an additional alternative in the case of a defined benefit plan, future benefit payments can be reduced;
- If contributions to a defined contribution plan have been allocated based on compensation in excess of the § 401(a)(17) limit, then the excess allocation can be reallocated to other participants or used to reduce future employer contributions or, as an additional alternative, under the Walk-in Closing Agreement Program ("Walk-in CAP"), additional plan contributions can be made for other employees;
- If hardship distributions that were not permitted under plan terms have been made, then, in accordance with specified requirements, a corrective plan

amendment can be made under Walk-in CAP; and
- If corrective contributions or allocations are made under a defined contribution plan, several alternative methods are provided for adjustments to reflect earnings.

This revenue procedure also expands the SVP correction method for the exclusion of eligible employees from elective deferrals, employee after-tax contributions, and matching contributions for a full year to include partial year exclusions, and clarifies the SVP correction method for exclusion of eligible employees from employer nonelective contributions under profit-sharing and stock bonus plans.

(4) The Service anticipates that the methods and examples described in this revenue procedure will be updated, and the methods and examples may be supplemented or expanded. In addition, the Service will continue to monitor and improve EPCRS as a whole, and accordingly, intends to revise Rev. Proc. 98–22 to reflect experience and public comments.

.02 *Background.* (1) Rev. Proc. 98–22, modified and consolidated into EPCRS the various Internal Revenue Service programs relating to correction of certain failures ("Qualification Failures"), which affect the qualification of a plan intended to be qualified under § 401(a) or 403(a) ("Qualified Plans"), or § 403(b) ("403(b) plans"). The programs consolidated into EPCRS include the Administrative Policy Regarding Self-Correction ("APRSC"), the Voluntary Compliance Resolution ("VCR") program, Walk-in CAP, and the Audit Closing Agreement Program ("Audit CAP"). Rev. Proc. 99–13, 1999–5 I.R.B. 52, modified and amplified Rev. Proc. 98–22 with respect to 403(b) plans.

(2) Section 6 of Rev. Proc. 98–22 sets forth correction principles that apply to all of the EPCRS programs. The standardized correction methods permitted under the Standardized VCR Procedure ("SVP") set forth in Appendix A of Rev. Proc. 98–22 are deemed to be reasonable and appropriate methods of correction for certain Qualification Failures that arise solely from failure to follow the terms of a plan ("Operational Failures"). Section 6.02(2) of Rev. Proc. 98–22 provides that there may be more than one reasonable and appropriate correction method for a Qualification Failure. Section 6.02(3) of Rev. Proc. 98–22 provides that corrective allocations under a defined contribution plan should be adjusted for earnings and forfeitures that would have been allocated to a participant's account if the failure had not occurred.

.03 *Overview.* (1) Section 2 of this revenue procedure describes the effect of this revenue procedure and taxpayers' ability to rely on it.

(2) Section 3 sets forth certain provisions that generally apply with respect to the correction methods and earnings adjustment methods under this revenue procedure, and assumptions that apply for purposes of the examples in this revenue procedure.

(3) Section 4 sets forth a number of reasonable and appropriate correction methods (and examples) that may be used to correct specific Operational Failures. Section 4 also clarifies and expands on certain correction methods under SVP. Consistent with section 6.02(2) of Rev. Proc. 98–22, other correction methods, different from those illustrated in this revenue procedure, may also be considered reasonable and appropriate for the same Operational Failure.

(4) Section 5 sets forth earnings adjustment methods (and examples) that may be used to adjust a corrective contribution or allocation for earnings in a defined contribution plan. Consequently, these earnings adjustment methods may be used to determine the earnings adjustments for corrective contributions or allocations under the correction methods in section 4 and under certain SVP correction methods. Other earnings adjustment methods, different from those illustrated in this revenue procedure, may also be appropriate for adjusting corrective contributions or allocations to reflect earnings.

.04 *Request for Comments.* The Service solicits comments and suggestions relating to this revenue procedure. In particular, the Service requests (1) comments on the correction methods, earnings adjustment methods, and examples described in this revenue procedure, (2) suggestions for alternative methods of correction for the Operational Failures addressed in this revenue procedure, and (3) suggestions for methods of correction for Qualification Failures not addressed in this revenue procedure (including methods for correcting failures with respect to 403(b) plans). It is requested that comments and suggestions be submitted by November 21, 1999, addressed to CC:DOM:CORP:R (Rev. Proc. 99–31), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand-delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Rev. Proc. 99–31), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may transmit comments electronically by using the following site: cynthia. grigsby@m1. irscounsel.treas.gov

SECTION 2. EFFECT OF THIS REVENUE PROCEDURE; RELIANCE

.01 *Effect of this Revenue Procedure.* If an Operational Failure addressed in this revenue procedure is corrected in the specific manner described in an applicable correction method set forth in this revenue procedure, the Service will treat the correction as a reasonable and appropriate correction for the Operational Failure under section 6.02(2) of Rev. Proc. 98–22. In addition, if an earnings adjustment is made to a corrective contribution or allocation under a defined contribution plan in a specific manner described in section 5 of this revenue procedure, the Service will treat the earnings adjustment as satisfying the requirement of section 6.02(3)(a) of Rev. Proc. 98–22 that corrective allocations in a defined contribution plan be adjusted for earnings.

.02 *Revenue Procedure Not Applicable to 403(b) Plans.* This revenue procedure does not apply to 403(b) plans. Accordingly, sponsors of 403(b) plans cannot rely on the correction methods under section 4 and the earnings adjustment methods under section 5. For guidance relating to 403(b) plans, see Rev. Proc. 99–13.

.03 *Reliance.* Taxpayers may rely on Rev. Proc. 98–22, as supplemented by this revenue procedure. Accordingly, if an Operational Failure addressed in this revenue procedure is corrected in accordance with the requirements of APRSC, VCR, Walk-in CAP, or Audit CAP, whichever is applicable; the eligibility requirements set forth in section 4 of Rev. Proc. 98–22 for the applicable program are satisfied; and the Operational Failure is corrected using an applicable correction method described in this revenue procedure that otherwise satisfies section 6.02 of Rev. Proc. 98–22, then, in accordance with section 3 of Rev. Proc. 98–22, the plan will not be disqualified by reason of the Operational Failure.

.04 *Effect of Future Guidance.* The Service expects that the correction methods and earnings adjustment methods described in this revenue procedure will be updated periodically in light of experience gained and comments received. However, taxpayers will be able to continue to rely on the correction methods and earnings adjustment methods in this revenue procedure for corrections prior to the publication of future guidance.

SECTION 3. GENERALLY APPLICABLE PROVISIONS

.01 *General.* Unless otherwise specified, the provisions of this section 3 apply for purposes of the correction methods in section 4 and the earnings adjustment methods in section 5 of this revenue procedure.

.02 *Correction Should Not Violate §401(a).* As provided in Rev. Proc. 98–22, section 6.02(2)(d), the correction method used to correct an Operational Failure should not violate § 401(a). If an additional Qualification Failure is created as a result of the use of a correction method in this revenue procedure, then that Qualification Failure also must be corrected in conjunction with the use of that correction method and in accordance with the requirements of EPCRS.

.03 *Consistency Requirement.* Generally, where more than one correction method is available to correct a type of Operational Failure for a plan year (or where there are alternative ways to apply a correction method), the correction method (or alternative ways to apply the correction method) should be applied consistently in correcting all Operational Failures of that type for that plan year. Similarly, earnings adjustment methods generally should be applied consistently with respect to corrective contributions or allocations for a particular type of Operational Failure for a plan year.

.04 *Treatment of Excess Amounts.* A distribution of an Excess Amount is not eligible for the favorable tax treatment accorded to distributions from qualified plans (such as eligibility for rollover under § 402(c)). To the extent that a current or prior distribution was a distribution of an Excess Amount, that distribution is not an eligible rollover distribution. Thus, for example, if such a distribution was contributed to an individual retirement arrangement ("IRA"), the contribution is not a valid rollover contribution for purposes of determining the amount of excess contributions (within the meaning of § 4973) to the individual's IRAs. Where an Excess Amount has been distributed in connection with an Operational Failure that is being corrected using a correction method set forth in section 4, the employer must notify the recipient that (1) the Excess Amount was distributed and (2) the Excess Amount was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover).

.05 *No Effect on Other Law.* In accordance with section 6.06 of Rev. Proc. 98–22, compliance under these programs has no effect on the rights of any party under any other law, including Title I of the Employee Retirement Income Security Act of 1974.

.06 *Definitions.* (1) Definitions from Rev. Proc. 98–22. The definitions set forth in section 5 of Rev. Proc. 98–22 apply for purposes of this revenue procedure.

(2) Excess Amount Defined. For purposes of this revenue procedure, an Excess Amount is (a) an Overpayment (within the meaning of section 4.05(2)), (b) an elective deferral or employee after-tax contribution returned to satisfy § 415, (c) an elective deferral in excess of the limitation of § 402(g) that is distributed, (d) an excess contribution or excess aggregate contribution that is distributed to satisfy § 401(k) or § 401(m), or (e) any similar amount required to be distributed in order to maintain plan qualification.

.07 *Assumptions for Examples.* Unless otherwise specified, for ease of presentation, the examples assume that:

(1) the plan year and the § 415 limitation year are the calendar year;

(2) the employer maintains a single plan intended to satisfy § 401(a) and has never maintained any other plan;

(3) in a defined contribution plan, the plan provides that forfeitures are used to reduce future employer contributions;

(4) the Qualification Failures are Operational Failures and the eligibility and other requirements for APRSC, VCR, Walk-in CAP, or Audit CAP, whichever applies, are satisfied; and

(5) there are no Qualification Failures other than the described Operational Failures, and if a corrective action would result in any additional Qualification Failure, appropriate corrective action is taken for that additional Qualification Failure in accordance with EPCRS.

SECTION 4. CORRECTION METHODS AND EXAMPLES

.01 *ADP/ACP Failures.*

(1) Correction Methods. (a) SVP Correction Method. Appendix A, section .03 of Rev. Proc. 98–22 sets forth the SVP correction method for a failure to satisfy the actual deferral percentage ("ADP"), actual contribution percentage ("ACP"), or multiple use test set forth in §§ 401(k)(3), 401(m)(2), and 401(m)(9), respectively.

(b) One-to-One Correction Method. (i) General. In addition to the SVP correction method, a failure to satisfy the ADP, ACP, or multiple use test may be corrected using the one-to-one correction method set forth in this section 4.01(1)(b). Under the one-to-one correction method, an excess contribution amount is determined and assigned to highly compensated employees as provided in paragraph (1)(b)(ii) below. That excess contribution amount (adjusted for earnings) is either distributed to highly compensated employees or forfeited from highly compensated employees' accounts as provided in paragraph (1)(b)(iii) below. That same dollar amount (i.e., the excess contribution amount, adjusted for earnings) is contributed to the plan and allocated to nonhighly compensated employees as provided in paragraph (1)(b)(iv) below.

(ii) Determination of the Excess Contribution Amount. The excess contribution amount for the year is equal to the excess of (A) the sum of the excess contributions (as defined in § 401(k)(8)(B)), the excess aggregate contributions (as defined in § 401(m)(6)(B)), and the amount treated as excess contributions or excess aggregate contributions under the multiple use test pursuant to § 401(m)(9) and

§ 1.401(m)–2(c) of the Income Tax Regulations for the year, as assigned to each highly compensated employee in accordance with § 401(k)(8)(C) and (m)(6)(C), over (B) previous corrections permitted under § 401(k)(8), (m)(6), and (m)(9). See Notice 97–2, 1997–1 C.B. 348.

(iii) Distributions and Forfeitures of the Excess Contribution Amount. (A) The portion of the excess contribution amount assigned to a particular highly compensated employee under paragraph (1)(b)(ii) is adjusted for earnings through the date of correction. The amount assigned to a particular highly compensated employee, as adjusted, is distributed or, to the extent the amount is forfeitable as of the close of the plan year of the failure, is forfeited. If the amount is forfeited, it is used in accordance with the plan provisions relating to forfeitures that were in effect for the year of the failure. If the amount so assigned to a particular highly compensated employee has been previously distributed, the amount is an Excess Amount within the meaning of section 3.06(2). Thus, pursuant to section 3.04, the employer must notify the employee that the Excess Amount was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover).

(B) If any matching contributions (adjusted for earnings) are forfeited in accordance with § 411(a)(3)(G), the forfeited amount is used in accordance with the plan provisions relating to forfeitures that were in effect for the year of the failure.

(C) If a payment was made to an employee and that payment is a forfeitable match described in either paragraph 4.01(b)(iii)(A) or (B), then it is an Overpayment defined in section 4.05(2) that must be corrected (see section 4.05(1)).

(iv) Contribution and Allocation of Equivalent Amount. (A) The employer makes a contribution to the plan that is equal to the aggregate amounts distributed and forfeited under paragraph (1)(b)(iii)(A) (i.e., the excess contribution amount adjusted for earnings, as provided in paragraph (1)(b)(iii)(A), which does not include any matching contributions forfeited in accordance with § 411(a)(3)(G), as provided in paragraph (1)(b)(iii)(B)). The contribution must satisfy the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C).

(B)(*1*) This paragraph (1)(b)(iv)(B)(*1*) applies to a plan that uses the current year testing method described in Notice 98-1, 1998–3 I.R.B. 42. The contribution made under paragraph (1)(b)(iv)(A) is allocated to the account balances of those individuals who were either (I) the eligible employees for the year of the failure who were not highly compensated employees for that year or (II) the eligible employees for the year of the failure who were not highly compensated employees for that year and who also are not highly compensated employees for the year of correction. Alternatively, the contribution is allocated to account balances of eligible employees described in (I) or (II) of the preceding sentence, except that the allocation is made only to the account balances of those employees who are employees on a date during the year of the correction that is no later than the date of correction. Regardless of which of these four options (described in the two preceding sentences) the employer selects, the contribution is allocated to each such employee either as the same percentage of the employee's compensation for the year of the failure or as the same dollar amount for each employee. (See Examples 1, 2 and 3.) Under the one-to-one correction method, the amount allocated to the account balance of an employee (i.e., the employee's share of the total amount contributed under paragraph (1)(b)(iv)(A)) is not further adjusted for earnings and is treated as an annual addition under § 415 for the year of the failure for the employee for whom it is allocated.

(*2*) This paragraph (1)(b)(iv)(B)(*2*) applies to a plan that uses the prior year testing method described in Notice 98–1. Paragraph (1)(b)(iv)(B)(*1*) is applied by substituting "the year prior to the year of the failure" for "the year of the failure".

(2) Examples.

Example 1:

Employer A maintains a profit-sharing plan with a cash or deferred arrangement that is intended to satisfy § 401(k) ("401(k) plan") using the current year testing method described in Notice 98-1. The plan does not provide for matching contributions or employee after-tax contributions. In 1999, it was discovered that the ADP test for 1997 was not performed correctly. When the ADP test was performed correctly, the test was not satisfied for 1997. For 1997, the ADP for highly compensated employees was 9% and the ADP for nonhighly compensated employees was 4%. Accordingly, the ADP for highly compensated employees exceeded the ADP for nonhighly compensated employees by more than two percentage points (in violation of § 401(k)(3)). (The ADP for nonhighly compensated employees for 1996 also was 4%, so the ADP test for 1997 would not have been satisfied even if the plan had used the prior year testing method described in Notice 98–1.) There were two highly compensated employees eligible under the 401(k) plan during 1997, Employee P and Employee Q. Employee P made elective deferrals of $8,000, which is equal to 10% of Employee P's compensation of $80,000 for 1997. Employee Q made elective deferrals of $9,500, which is equal to 8% of Employee Q's compensation of $118,750 for 1997.

Correction:

On June 30, 1999, Employer A uses the one-to-one correction method to correct the failure to satisfy the ADP test for 1997. Accordingly, Employer A calculates the dollar amount of the excess contributions for the two highly compensated employees in the manner described in § 401(k)(8)(B). The amount of the excess contribution for Employee P is $3,200 (4% of $80,000) and the amount of the excess contribution for Employee Q is $2,375 (2% of $118,750), or a total of $5,575. In accordance with § 401(k)(8)(C), $5,575, the excess contribution amount, is assigned $2,037.50 to Employee P and $3,537.50 to Employee Q. It is determined that the earnings on the assigned amounts through June 30, 1999 are $407 and $707 for Employees P and Q, respectively. The assigned amounts and the earnings are distributed to Employees P and Q. Therefore, Employee P receives $2,444.50 ($2,037.50 + $407) and Employee Q receives $4,244.50 ($3,537.50 + $707). In addition, on the same date, a corrective contribution is made to the 401(k) plan equal to $6,689 (the sum of the $2,444.50 distributed to Employee P and the $4,244.50 distributed to Employee Q). The corrective contribution is allocated to the account balances of eligible nonhighly compensated employees for 1997, pro rata based on their compensation for 1997 (subject to § 415 for 1997).

Example 2:

The facts are the same as in Example 1.

Correction:

The correction is the same as in Example 1, except that the corrective contribution of $6,689 is allocated in an equal dollar amount to the account balances of eligible nonhighly compensated employees for 1997 who are employees on June 30, 1999 and who are nonhighly compensated employees for 1999 (subject to § 415 for 1997).

Example 3:

The facts are the same as in Example 1, except that for 1997 the plan also provides (1) for employee after-tax contributions and (2) for matching contributions equal to 50% of the sum of an employee's elective deferrals and employee after-tax contributions that do not exceed 10% of the employee's compensation. The plan provides that matching contributions are subject to the plan's 5-year graded vesting schedule and that matching contributions are forfeited and used to reduce employer contributions if associated elective deferrals or employee after-tax contributions are distributed to correct an ADP, ACP or multiple use test failure. For 1997, nonhighly compensated employees made employee after-tax contributions and no highly compensated employee made any employee after-tax contributions. Employee P received a matching contribution of $4,000 (50% of $8,000) and Employee Q received a matching contribution of $4,750 (50% of $9,500). Employees P and Q were 100% vested in 1997. It is determined that, for 1997, the ACP for highly compensated employees was not more than 125% of the ACP for nonhighly compensated employees, so that the ACP and multiple use tests would have been satisfied for 1997 without any corrective action.

Correction:

The same corrective actions are taken as in Example 1. In addition, in accordance with the plan's terms, corrective action is taken to forfeit Employee P's and Employee Q's matching contributions associated with their distributed excess contributions. Employee P's distributed excess contributions and associated matching contributions are $2,037.50 and $1,018.75, respectively. Employee Q's distributed excess contributions and associated matching contributions are $3,537.50 and $1,768.75, respectively. Thus, $1,018.75 is forfeited from Employee P's account and $1,768.75 is forfeited from Employee Q's account. In addition, the earnings on the forfeited amounts are also forfeited. It is determined that the respective earnings on the forfeited amount for Employee P is $150 and for Employee Q is $204. The total amount of the forfeitures of $3,141.50 (Employee P's $1,018.75 + $150 and Employee Q's $1,768.75 + $204) is used to reduce contributions for 1999 and subsequent years.

.02 *Exclusion of Eligible Employees.*

(1) Exclusion of Eligible Employees in a 401(k) or (m) Plan. (a) Correction Method. (i) SVP Correction Method for Full Year Exclusion. Appendix A, section .05 of Rev. Proc. 98–22 sets forth the SVP correction method for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for one or more full plan years. (See Example 4.) In section 4.02(1)(a)(ii) below, the SVP correction method for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for a full year is expanded to include correction for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for a partial plan year. This correction for a partial year exclusion may be used in conjunction with the correction for a full year exclusion.

(ii) Expansion of SVP Correction Method to Partial Year Exclusion. (A) In General. The correction method in Appendix A, section .05 of Rev. Proc. 98–22 is expanded to cover an employee who was improperly excluded from making elective deferrals or employee after-tax contributions for a portion of a plan year or from receiving matching contributions (on either elective deferrals or employee after-tax contributions) for a portion of a plan year. In such case, the permitted correction method under SVP for the failure is for the employer to satisfy this section 4.02(1)(a)(ii). The employer makes a corrective contribution on behalf of the excluded employee that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C).

(B) Elective Deferral Failures. The appropriate corrective contribution for the failure to allow employees to make elective deferrals for a portion of the plan year is equal to the ADP of the employee's group (either highly or nonhighly compensated), determined prior to correction under this section 4.02(1)(a)(ii), multiplied by the employee's plan compensation for the portion of the year during which the employee was improperly excluded. The corrective contribution for the portion of the plan year during which the employee was improperly excluded from being eligible to make elective deferrals is reduced to the extent that (*1*) the sum of that contribution and any elective deferrals actually made by the employee for that year would exceed (*2*) the maximum elective deferrals permitted under the plan for the employee for that plan year (including the § 402(g) limit). The corrective contribution is adjusted for earnings. (See Examples 5 and 6.)

(C) Employee After-Tax and Matching Contribution Failures. The appropriate corrective contribution for the failure to allow employees to make employee after-tax contributions or to receive matching contributions because the employee was precluded from making employee after-tax contributions or elective deferrals for a portion of the plan year is equal to the ACP of the employee's group (either highly or nonhighly compensated), determined prior to correction under this section 4.02(1)(a)(ii), multiplied by the employee's plan compensation for the portion of the year during which the employee was improperly excluded. The corrective contribution is reduced to the extent that (*1*) the sum of that contribution and the actual total employee after-tax and matching contributions made by and for the employee for the plan year would exceed (*2*) the sum of the maximum employee after-tax contributions permitted under the plan for the employee for the plan year and the matching contributions that would have been made if the employee had made the maximum matchable contributions permitted under the plan for the employee for that plan year. The corrective contribution is adjusted for earnings.

(D) Use of Prorated Compensation. For purposes of this paragraph (1)(a)(ii), for administrative convenience, in lieu of using the employee's actual plan compensation for the portion of the year during which the employee was improperly excluded, a pro rata portion of the employee's plan compensation that would have been taken into account for the plan year, if the employee had not been improperly excluded, may be used.

(E) Special Rule for Brief Exclusion from Elective Deferrals. An employer is not required to make a corrective contribution with respect to elective deferrals, as provided in section 4.02(1)(a)(ii)(B), (but is required to make a corrective contribution with respect to any employee after-tax and matching contributions, as provided in section 4.02(1)(a)(ii)(C)) for an employee for a plan year if the employee has been provided the opportunity to make elective deferrals under the plan for a period of at least the last 9 months in that plan year and during that period the employee had the opportunity to make elective deferrals in an amount not less than the maximum amount that would have been permitted if no failure had occurred. (See Example 7.)

(b) Examples.

Example 4:

Employer B maintains a 401(k) plan. The plan provides for matching contributions for eligible employees equal to 100% of elective deferrals that do not exceed 3% of an employee's compensation. The plan provides that employees who complete one year of service are eligible to participate in the plan on the next January 1 or July 1 entry date. Twelve employees (8 nonhighly compensated employees and 4 highly compensated employees) who had met the one year eligibility requirement after July 1, 1995 and before January 1, 1996 were inadvertently excluded from participating in the plan beginning on January 1, 1996. These employees were offered the opportunity to begin participating in the plan on January 1, 1997. For 1996, the ADP for the highly compensated employees was 8% and the ADP for the nonhighly compensated employees was 6%. In addition, for 1996, the ACP for the highly compensated employees was 2.5% and the ACP for the nonhighly compensated employees was 2%. The failure to include the 12 employees was discovered during 1998.

Correction:

Employer B uses the SVP correction method for full year exclusions to correct the failure to include the 12 eligible employees in the plan for the full plan year beginning January 1, 1996. Thus, Employer B makes a corrective contribution (that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C)) for each of the excluded employees. The contribution for each of the improperly excluded highly compensated employees is 10.5% (the highly compensated employees' ADP of 8% plus ACP of 2.5%) of the employee's plan compensation for the 1996 plan year (adjusted for earnings). The contribution for each of the improperly excluded nonhighly compensated employees is 8% (the nonhighly compensated employees' ADP of 6% plus ACP of 2%) of the employee's plan compensation for the 1996 plan year (adjusted for earnings).

Example 5:

Employer C maintains a 401(k) plan. The plan provides for matching contributions for each payroll period that are equal to 100% of an employee's elective deferrals that do not exceed 2% of the eligible employee's plan compensation during the payroll period. The plan does not provide for employee after-tax contributions. The plan provides that employees who complete one year of service are eligible to participate in the plan on the next January 1 or July 1 entry date. A nonhighly compensated employee who met the eligibility requirements and should have entered the plan on January 1, 1996 was not offered the opportunity to participate in the plan. In August of 1996, the error was discovered and Employer C offered the employee an election opportunity as of September 1, 1996. The employee made elective deferrals equal to 4% of the employee's plan compensation for each payroll period from September 1, 1996 through December 31, 1996 (resulting in elective deferrals of $500). The employee's plan compensation for 1996 was $36,000 ($23,500 for the first eight months and $12,500 for the last four months). Employer C made matching contributions equal to $250 for the excluded employee, which is 2% of the employee's plan compensation for each payroll period from September 1, 1996 through December 31, 1996 ($12,500). The ADP for nonhighly compensated employees for 1996 was 3% and the ACP for nonhighly compensated employees for 1996 was 1.8%.

Correction:

Employer C uses the SVP correction method for partial year exclusions to correct the failure to include the eligible employee in the plan. Thus, Employer C makes a corrective contribution (that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C)) for the excluded employee. In determining the amount of corrective contributions (both for the elective deferral and for the matching contribution), for administrative convenience, in lieu of using actual plan compensation of $23,500 for the period the employee was excluded, the employee's annual plan compensation is pro rated for the eight-month period that the employee was excluded from participating in the plan. The failure to provide the excluded employee the right to make elective deferrals is corrected by the employer making a corrective contribution on behalf of the employee that is equal to $720 (the 3% ADP percentage for nonhighly compensated employees multiplied by $24,000, which is 8/12ths of the employee's 1996 plan compensation of $36,000), adjusted for earnings. In addition, to correct for the failure to receive the plan's matching contribution, a corrective contribution is made on behalf of the employee that is equal to $432 (the 1.8% ACP for the nonhighly compensated group multiplied by $24,000, which is 8/12ths of the employee's 1996 plan compensation of $36,000), adjusted for earnings. Employer C determines that $682, the sum of the actual matching contribution received by the employee for the plan year ($250) and the corrective contribution to correct the matching contribution failure ($432), does not exceed $720, the maximum matching contribution available to the employee under the plan (2% of $36,000) determined as if the employee had made the maximum matchable contributions. In addition to correcting the failure to include the eligible employee in the plan, Employer C reruns the ADP and ACP tests for 1996 (taking into account the corrective contribution and plan compensation for 1996 for the excluded employee) and determines that the tests were satisfied.

Example 6:

The facts are the same as in Example 5, except that the plan provides for matching contributions that are equal to 100% of an eligible employee's elective deferrals that do not exceed 2% of the employee's plan compensation for the plan year. Accordingly, the actual matching contribution made by Employer C for the excluded employee for the last four months of 1996 is $500 (which is equal to 100% of the $500 of elective deferrals made by the employee for the last four months of 1996).

Correction:

The correction is the same as in Example 5, except that the corrective contribution made for the first 8 months of 1996 to correct the failure to make matching contributions is equal to $220 (adjusted for earnings), instead of the $432 (adjusted for earnings) in Example 5, because the corrective contribution is limited to the maximum matching contributions available under the plan for the employee for the plan year, $720 (2% of $36,000), reduced by the actual matching contributions made for the employee for the plan year, $500.

Example 7:

The facts are the same as in Example 5, except that the error is discovered in March of 1996 and the employee was given the opportunity to make elective deferrals beginning on April 1, 1996. The amount of elective deferrals that the employee was given the opportunity to make during 1996 was not less than the maximum elective deferrals that the employee could have made if the employee had been given the opportunity to make elective deferrals beginning on January 1, 1996. The employee made elective deferrals equal to 4% of the employee's plan compensation for each payroll period from April 1, 1996 through December 31, 1996 of $28,000 (resulting in elective deferrals of $1,120). Employer C made a matching contribution equal to $560, which is 2% of the employee's plan compensation for each payroll period from April 1, 1996 through December 31, 1996 ($28,000). The employee's plan compensation for 1996 was $36,000 ($8,000 for the first three months and $28,000 for the last nine months).

Correction:

Employer C uses the SVP correction method for partial year exclusions to correct the failure to include an eligible employee in the plan. Because the employee was given an opportunity to make elective deferrals to the plan for at least the last 9 months of the plan year (and the amount of the elective deferrals that the employee had the opportunity to make was not less than the maximum elective deferrals that the employee could have made if the employee had been given the opportunity to make elective deferrals beginning on January 1, 1996), under the special rule set forth in section 4.02(1)(a)(ii)(E), Employer C is not required to make a corrective contribution for the failure to allow the employee to make elective deferrals. In determining the amount of corrective contribution with respect to the failure to allow the employee to receive matching contributions, in lieu of using actual plan compensation of $8,000 for the period the employee was excluded, the employee's annual plan compensation is pro rated for the three-month period that the employee was excluded from participating in the plan. Accordingly, a corrective contribution is made on behalf of the employee that is equal to $160, which is the lesser of (i) $162 (a matching contribution of 1.8% of $9,000, which is 3/12ths of the employee's 1996 plan compensation of $36,000), and (ii) $160 (the excess of the maximum matching contribution for the entire plan year, which is equal to 2% of $36,000, or $720, over the matching contributions made after March 31, 1996, $560). The contribution is adjusted for earnings.

(2) Exclusion of Eligible Employees In a Profit-Sharing Plan.

(a) Correction Methods. (i) SVP Correction Method. Appendix A, section .05 of Rev. Proc. 98–22 sets forth the SVP correction method for correcting the exclusion of an eligible employee. In the case of a defined contribution plan, the SVP correction method is to make a contribution on behalf of the excluded employee. Section 4.02(2)(a)(ii) below clarifies the SVP correction method in the case of a profit-sharing or stock bonus plan that provides for nonelective contributions (within the meaning of § 1.401(k)–1(g)(10)).

(ii) Clarification of SVP Correction Method for Profit-Sharing Plans. To correct for the exclusion of an eligible employee from nonelective contributions in a profit-sharing or stock bonus plan under the SVP correction method, an allocation amount is determined for each excluded employee on the same basis as the allocation amounts were determined for the other employees under the plan's allocation formula (e.g., the same ratio of allocation to compensation), taking into account all of the employee's relevant factors (e.g., compensation) under that formula for that year. The employer makes a corrective contribution on behalf of the excluded employee that is equal to the allocation amount for the excluded employee. The corrective contribution is adjusted for earnings. If, as a result of excluding an employee, an amount was improperly allocated to the account balance of an eligible employee who shared in the original allocation of the nonelective contribution, no reduction is made to the account balance of the employee who shared in the original allocation on account of the improper allocation. (See Example 8.)

(iii) Reallocation Correction Method. (A) In General. Subject to the limitations set forth in section 4.02(2)(a)(iii)(F) below, in addition to the SVP correction method, the exclusion of an eligible employee for a plan year from a profit-sharing or stock bonus plan that provides for nonelective contributions may be corrected using the reallocation correction method set forth in this section 4.02(2)(a)(iii). Under the reallocation correction method, the account balance of the excluded employee is increased as provided in paragraph (2)(a)(iii)(B) below, the account balances of other employees are reduced as provided in paragraph (2)(a)(iii)(C) below, and the increases and reductions are reconciled, as necessary, as provided in paragraph (2)(a)(iii)(D) below. (See Examples 9 and 10.)

(B) Increase in Account Balance of Excluded Employee. The account balance of the excluded employee is increased by an amount that is equal to the allocation the employee would have received had the employee shared in the allocation of the nonelective contribution. The amount is adjusted for earnings.

(C) Reduction in Account Balances of Other Employees. (*1*) The account balance of each employee who was an eligible employee who shared in the original allocation of the nonelective contribution is reduced by the excess, if any, of (I) the employee's allocation of that contribution over (II) the amount that would have been allocated to that employee had the failure not occurred. This amount is adjusted for earnings taking into account the rules set forth in section 4.02(2)(a)(iii)(C)(*2*) and (*3*) below. The amount after adjustment for earnings is limited in accordance with section 4.02(2)(a)(iii)(C)(*4*) below.

(*2*) This paragraph (2)(a)(iii)(C)(*2*) applies if most of the employees with account balances that are being reduced are nonhighly compensated employees. If there has been an overall gain for the period from the date of the original allocation of the contribution through the date of correction, no adjustment for earnings is required to the amount determined under section 4.02(2)(a)(iii)(C)(*1*) for the employee. If the amount for the employee is being adjusted for earnings and the plan permits investment of account balances in more than one investment fund, for administrative convenience, the reduction to the employee's account balance may be adjusted by the lowest earnings rate of any fund for the period from the date of the original allocation of the contribution through the date of correction.

(*3*) If an employee's account balance is reduced and the original allocation was made to more than one investment fund or there was a subsequent distribution or transfer from the fund receiving the original allocation, then, reasonable, consistent assumptions are used to determine the earnings adjustment.

(*4*) The amount determined in section 4.02(2)(a)(iii)(C)(*1*) for an employee after the application of section 4.02(2)(a)(iii)-(C)(*2*) and (*3*) may not exceed the account balance of the employee on the date of correction, and the employee is permitted to retain any distribution made prior to the date of correction.

(D) Reconciliation of Increases and Reductions. If the aggregate amount of the increases under section 4.02(2)(a)-(iii)(B) exceeds the aggregate amount of the reductions under section 4.02(2)(a)-(iii)(C), the employer makes a corrective contribution to the plan for the amount of the excess. If the aggregate amount of the reductions under section 4.02(2)(a)-(iii)(C) exceeds the aggregate amount of the increases under section 4.02(2)(a)-(iii)(B), then the amount by which each employee's account balance is reduced under section 4.02(2)(a)(iii)(C) is decreased on a pro rata basis.

(E) Reductions Among Multiple Investment Funds. If an employee's account balance is reduced and the employee's account balance is invested in more than one investment fund, then the reduction may be made from the investment funds selected in any reasonable manner.

(F) Limitations on Use of Reallocation Correction Method. If any employee would be permitted to retain any distribution pursuant to section 4.02(2)(a)-(iii)(C)(4), then the reallocation correction method may not be used unless most of the employees who would be permitted to retain a distribution are nonhighly compensated employees.

(b) Examples.

Example 8:

Employer D maintains a profit-sharing plan that provides for discretionary nonelective employer contributions. The plan provides that the employer's contributions are allocated to account balances in the ratio that each eligible employee's compensation for the plan year bears to the compensation of all eligible employees for the plan year and, therefore, the only relevant factor for determining an allocation is the employee's compensation. The plan provides for self-directed investments among four investment funds and daily valuations of account balances. For the 1997 plan year, Employer D made a contribution to the plan of a fixed dollar amount. However, five employees who met the eligibility requirements were inadvertently excluded from participating in the plan. The contribution resulted in an allocation on behalf of each of the eligible employees, other than the excluded employees, equal to 10% of compensation. Most of the employees who received allocations under the plan for the year of the failure were nonhighly compensated employees. No distributions have been made from the plan since 1997. If the five excluded employees had shared in the original allocation, the allocation made on behalf of each employee would have equaled 9% of compensation. The excluded employees began participating in the plan in the 1998 plan year.

Correction:

Employer D uses the SVP correction method to correct the failure to include the five eligible employees. Thus, Employer D makes a corrective contribution to the plan. The amount of the corrective contribution on behalf of the five excluded employees for the 1997 plan year is equal to 10% of compensation of each excluded employee, the same allocation that was made for other eligible employees, adjusted for earnings. The excluded employees receive an allocation equal to 10% of compensation (adjusted for earnings) even though, had the excluded employees originally shared in the allocation for the 1997 contribution, their account balances, as well as those of the other eligible employees, would have received an allocation equal to only 9% of compensation.

Example 9:

The facts are the same as in Example 8.

Correction:

Employer D uses the reallocation correction method to correct the failure to include the five eligible employees. Thus, the account balances are adjusted to reflect what would have resulted from the correct allocation of the employer contribution for the 1997 plan year among all eligible employees, including the five excluded employees. The inclusion of the excluded employees in the allocation of that contribution would have resulted in each eligible employee, including each excluded employee, receiving an allocation equal to 9% of compensation. Accordingly, the account balance of each excluded employee is increased by 9% of the employee's 1997 compensation, adjusted for earnings. The account balance of each of the eligible employees other than the excluded employees is reduced by 1% of the employee's 1997 compensation, adjusted for earnings. Employer D determines the adjustment for earnings using the earnings rate of each eligible employee's excess allocation (using reasonable, consistent assumptions). Accordingly, for an employee who shared in the original allocation and directed the investment of the allocation into more than one investment fund or who subsequently transferred a portion of a fund that had been credited with a portion of the 1997 allocation to another fund, reasonable, consistent assumptions are followed to determine the adjustment for earnings. It is determined that the total of the initially determined reductions in account balances exceeds the total of the required increases in account balances. Accordingly, these initially determined reductions are decreased pro rata so that the total of the actual reductions in account balances equals the total of the increases in the account balances, and Employer D does not make any corrective contribution. The reduction from the account balances are made on a pro rata basis among all of the funds in which each employee's account balance is invested.

Example 10:

The facts are the same as in Example 8.

Correction:

The correction is the same as in Example 9, except that, because most of the employees whose account balances are being reduced are nonhighly compensated employees, for administrative convenience, Employer D uses the earnings rate of the fund with the lowest earnings rate for the period of the failure to adjust the reduction to each account balance. It is determined that the aggregate amount (adjusted for earnings) by which the account balances of the excluded employees is increased exceeds the aggregate amount (adjusted for earnings) by which the other employees' account balances are reduced. Accordingly, Employer D makes a contribution to the plan in an amount equal to the excess. The reduction from account balances is made on a pro rata basis among all of the funds in which each employee's account balance is invested.

.03 *Vesting Failures.*

(1) Correction Methods. (a) Contribution Correction Method. A failure in a defined contribution plan to apply the proper vesting percentage to an employee's account balance that results in forfeiture of too large a portion of the employee's account balance may be corrected using the contribution correction method set forth in this paragraph. The employer makes a corrective contribution on behalf of the employee whose account balance was improperly forfeited in an amount equal to the improper forfeiture. The corrective contribution is adjusted for earnings. If, as a result of the improper forfeiture, an amount was improperly allocated to the account balance of another employee, no reduction is made to the account balance of that employee. (See Example 11.)

(b) Reallocation Correction Method. In addition to the contribution correction method, in a defined contribution plan under which forfeitures of account balances are reallocated among the account balances of the other eligible employees in the plan, a failure to apply the proper vesting percentage to an employee's account balance which results in forfeiture of too large a portion of the employee's account balance may be corrected under the reallocation correction method set forth in this paragraph. A corrective reallocation is made in accordance with the reallocation correction method set forth in section 4.02(2)(a)(iii), subject to the limitations set forth in section 4.02(2)(a)(iii)(F). In applying section 4.02(2)(a)(iii)(B), the account balance of the employee who incurred the improper forfeiture is increased by an amount equal to the amount of the improper forfeiture and the amount is adjusted for earnings. In applying section 4.02(2)(a)(iii)(C)(*1*), the account balance of each employee who shared in the allocation of the improper forfeiture is reduced by the amount of the improper forfeiture that was allocated to that employee's account. The earnings adjustments for the account balances that are being reduced are determined in accordance with sections 4.02(2)(a)(iii)(C)(*2*) and (*3*) and the reductions after adjustments for earnings are limited in accordance with section 4.02(2)(a)(iii)(C)(*4*). In accordance with section 4.02(2)(a)(iii)(D), if the aggregate amount of the increases exceeds the aggregate amount of the reductions, the employer makes a corrective contribution to the plan for the amount of the excess. In accordance with section 4.02(2)(a)(iii)(D), if the aggregate amount of the reductions exceeds the aggregate amount of the increases, then the amount by which each employee's account balance is reduced is decreased on a pro rata basis. (See Example 12.)

(2) Examples.

Example 11:

Employer E maintains a profit-sharing plan that provides for nonelective contributions. The plan provides for self-directed investments among four investment funds and daily valuation of account balances. The plan provides that forfeitures of account balances are reallocated among the account balances of other eligible employees on the basis of compensation. During the 1997 plan year, Employee R terminated employment with Employer E and elected and received a single-sum distribution of the vested portion of his account balance. No other distributions have been made since 1997. However, an incorrect determination of Employee R's vested percentage was made resulting in Employee R receiving a distribution of less than the amount to which he was entitled under the plan. The remaining portion of Employee R's account balance was forfeited and reallocated (and these reallocations were not affected by the limitations of § 415). Most of the employees who received allocations of the improper forfeiture were nonhighly compensated employees.

Correction:

Employer E uses the contribution correction method to correct the improper forfeiture. Thus, Employer E makes a contribution on behalf of Employee R equal to the incorrectly forfeited amount (adjusted for earnings) and Employee R's account balance is increased accordingly. No reduction is made from the account balances of the employees who received an allocation of the improper forfeiture.

Example 12:

The facts are the same as in Example 11.

Correction:

Employer E uses the reallocation correction method to correct the improper forfeiture. Thus, Employee R's account balance is increased by the amount that was improperly forfeited (adjusted for earnings). The account of each employee who shared in the allocation of the improper forfeiture is reduced by the amount of the improper forfeiture that was allocated to that employee's account (adjusted for earnings). Because most of the employees whose account balances are being reduced are nonhighly compensated employees, for administrative convenience, Employer E uses the earnings rate of the fund with the lowest earnings rate for the period of the failure to adjust the reduction to each account balance. It is determined that the amount (adjusted for earnings) by which the account balance of Employee R is increased exceeds the aggregate amount (adjusted for earnings) by which the other employees' account balances are reduced. Accordingly, Employer E makes a contribution to the plan in an amount equal to the excess. The reduction from the account balances is made on a pro rata basis among all of the funds in which each employee's account balance is invested.

.04 *§ 415 Failures.*

(1) Failures Relating to a § 415(b) Excess.

(a) Correction Methods. (i) Return of Overpayment Correction Method. Overpayments as a result of amounts being paid in excess of the limits of § 415(b) may be corrected using the return of overpayment correction method set forth in this paragraph (1)(a)(i). The employer takes reasonable steps to have the Overpayment (with appropriate interest) returned by the recipient to the plan and reduces future benefit payments (if any) due to the employee to reflect § 415(b). To the extent the amount returned by the recipient is less than the Overpayment, adjusted for earnings at the plan's earnings rate, then the employer or another person contributes the difference to the plan. In addition, in accordance with section 3.04, the employer must notify the recipient that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). (See Examples 15 and 16.)

(ii) Adjustment of Future Payments Correction Method. (A) In General. In addition to the return of overpayment correction method, in the case of plan benefits that are being distributed in the form of periodic payments, Overpayments as a result of amounts being paid in excess of the limits in § 415(b) may be corrected by using the adjustment of future payments correction method set forth in this paragraph (1)(a)(ii). Future payments to the recipient are reduced so that they do not exceed the § 415(b) maximum limit and an additional reduction is made to recoup the Overpayment (over a period not longer than the remaining payment period) so that the actuarial present value of the additional reduction is equal to the Overpayment plus interest at the interest rate used by the plan to determine actuarial equivalence. (See Examples 13 and 14.)

(B) Joint and Survivor Annuity Payments. If the employee is receiving payments in the form of a joint and survivor annuity, with the employee's spouse to receive a life annuity upon the employee's death equal to a percentage (e.g., 75%) of the amount being paid to the employee, the reduction of future annuity payments to reflect § 415(b) reduces the amount of benefits payable during the lives of both the employee and spouse, but any reduction to recoup Overpayments made to the employee does not reduce the amount of the spouse's survivor benefit. Thus, the spouse's benefit will be based on the previous specified percentage (e.g., 75%) of the maximum permitted under § 415(b), instead of the reduced annual periodic amount payable to the employee.

(C) Overpayment Not Treated as an Excess Amount. An Overpayment corrected under this adjustment of future payment correction method, is not treated as an Excess Amount as defined in section 3.06(2).

(b) Examples.

Example 13:

Employer F maintains a defined benefit plan funded solely through employer contributions. The plan provides that the benefits of employees are limited to the maximum amount permitted under § 415(b), disregarding cost-of-living adjustments under § 415(d) after benefit payments have commenced. At the beginning of the 1998 plan year, Employee S retired and started receiving an annual straight life annuity of $140,000 from the plan. Due to an administrative error, the annual amount received by Employee S for 1998 included an Overpayment of $10,000 (because the § 415(b)(1)(A) limit for 1998 was $130,000). This error was discovered at the beginning of 1999.

Correction:

Employer F uses the adjustment of future payments correction method to correct the failure to satisfy the limit in § 415(b). Future annuity benefit payments to Employee S are reduced so that they do not exceed the § 415(b) maximum limit, and, in addition, Employee S's future benefit payments from the plan are actuarially reduced to recoup the Overpayment. Accordingly, Employee S's future benefit payments from the plan are reduced to $130,000 and further reduced by $1,000 annually for life, beginning in 1999. The annual benefit amount is reduced by $1,000 annually for life because, for Employee S, the actuarial present value of a benefit of $1,000 annually for life commencing in 1999 is equal to the sum of $10,000 and interest at the rate used by the plan to determine actuarial equivalence beginning with the date of the first Overpayment and ending with the date the reduced annuity payment begins. Thus, Employee S's remaining benefit payments are reduced so that Employee S receives $129,000 for 1999, and for each year thereafter.

Example 14:

The facts are the same as in Example 13.

Correction:

Employer F uses the adjustments of future payments correction method to correct the § 415(b) failure, by recouping the entire excess payment made in 1998 from Employee S's remaining benefit payments for 1999. Thus, Employee S's annual annuity benefit for 1999 is reduced to $119,400 to reflect the excess benefit amounts (increased by interest) that were paid from the plan to Employee S during the 1998 plan year. Beginning in 2000, Employee S begins to receive annual benefit payments of $130,000.

Example 15:

The facts are the same as in Example 13, except that the benefit was paid to Employee S in the form of a single-sum distribution in 1998, which exceeded the maximum § 415(b) limits by $110,000.

Correction:

Employer F uses the return of overpayment correction method to correct the § 415(b) failure. Thus, Employer F notifies Employee S of the $110,000 Overpayment and that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). The notice also informs Employee S that the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) is owed to the plan. Employer F takes reasonable steps to have the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) paid to the plan. Employee S pays the $110,000 (plus the requested interest) to the plan. It is determined that the plan's earnings rate for the relevant period was 2 percentage points more than the rate used by the plan to calculate the single-sum payment. Accordingly, Employer F contributes the difference to the plan.

Example 16:

The facts are the same as in Example 15.

Correction:

Employer F uses the return of overpayment correction method to correct the § 415(b) failure. Thus, Employer F notifies Employee S of the $110,000 Overpayment and that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). The notice also informs Employee S that the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) is owed to the plan. Employer F takes reasonable steps to have the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) paid to the plan. As a result of Employer F's recovery efforts, some, but not all, of the Overpayment (with interest) is recovered from Employee S. It is determined that the amount returned by Employee S to the plan is less than the Overpayment adjusted for earnings at the plan's earnings rate. Accordingly, Employer F contributes the difference to the plan.

(2) Failures Relating to a § 415(c) Excess.

(a) Correction Methods. (i) SVP Correction Method. Appendix A, section .08 of Rev. Proc. 98–22 sets forth the SVP correction method for correcting the failure to satisfy the § 415(c) limits on annual additions.

(ii) Forfeiture Correction Method. In addition to the SVP correction method, the failure to satisfy § 415(c) with respect to a nonhighly compensated employee (A) who in the limitation year of the failure had annual additions consisting of both (I) either elective deferrals or employee after-tax contributions and (II) either matching or nonelective contributions, (B) for whom the matching and nonelective contributions equal or exceed the portion of the employee's annual addition that exceeds the limits under § 415(c) ("§ 415(c) excess") for the limitation year, and (C) who has terminated with no vested interest in the matching and nonelective contributions (and has not been reemployed at the time of the correction), may be corrected by using the forfeiture correction method set forth in this paragraph. The § 415(c) excess is deemed to consist solely of the matching and nonelective contributions. If the employee's § 415(c) excess (adjusted for earnings) has previously been forfeited, the § 415(c) failure is deemed to be corrected. If the § 415(c) excess (adjusted for earnings) has not been forfeited, that amount is placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s) (or if the amount would have been allocated to other employees who were in the plan for the year of the failure if the failure had not occurred, then that amount is reallocated to the other employees in accordance with the plan's allocation formula). Note that while this correction method will permit more favorable tax treatment of elective deferrals for the employee than the SVP correction method, this correction method could be less favorable to the employee in certain cases, for example, if the employee is subsequently reemployed and becomes vested. (See Examples 17 and 18.)

(iii) Return of Overpayment Correction Method. A failure to satisfy § 415(c) that includes a distribution of the § 415(c) excess attributable to nonelective contributions and matching contributions may be corrected using the return of overpayment correction method set forth in this paragraph. The employer takes reasonable steps to have the Overpayment (i.e., the distribution of the 415(c) excess adjusted for earnings to the date of the distribution), plus appropriate interest from the date of the distribution to the date of the repayment, returned by the employee to the plan. To the extent the amount returned by the employee is less than the Overpayment adjusted for earnings at the plan's earnings rate, then the employer or another person contributes the difference to the plan. The Overpayment, adjusted for earnings at the plan's earnings rate to the date of the repayment, is to be placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s) (or if the amount would have been allocated to other eligible employees who were in the plan for the year of the failure if the failure had not occurred, then that amount is reallocated to the other eligible employees in accordance with the plan's allocation formula). In addition, the employer must notify the employee that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover).

(b) Examples.

Example 17:

Employer G maintains a 401(k) plan. The plan provides for nonelective employer contributions, elective deferrals, and employee after-tax contributions. The plan provides that the nonelective contributions vest under a 5-year cliff vesting schedule. The plan provides that when an employee terminates employment, the employee's nonvested account balance is forfeited five years after a distribution of the employee's vested account balance and that forfeitures are used to reduce employer contributions. For the 1998 limitation year, the annual additions made on behalf of two nonhighly compensated employees in the plan, Employees T and U, exceeded the limit in § 415(c). For the 1998 limitation year, Employee T had § 415 compensation of $60,000, and, accordingly, a § 415(c)(1)(B) limit of $15,000. Employee T made elective deferrals and employee after-tax contributions. For the 1998 limitation year, Employee U had § 415 compensation of $40,000, and, accordingly, a § 415(c)(1)(B) limit of $10,000. Employee U made elective deferrals. Also, on January 1, 1999, Employee U, who had three years of service with Employer G, terminated his employment and received his entire vested account balance (which consisted of his elective deferrals). The annual additions for Employees T and U consisted of:

	T	U
Nonelective Contributions	$7,500	$4,500
Elective Deferrals	10,000	5,800
After-tax Contributions	500	0
Total Contributions	$18,000	$10,300
§ 415(c) Limit	$15,000	$10,000
§ 415(c) Excess	$3,000	$300

Correction:

Employer G uses the SVP correction method to correct the § 415(c) excess with respect to Employee T (i.e., $3,000). Thus, a distribution of plan assets (and corresponding reduction of the account balance) consisting of $500 (adjusted for earnings) of employee after-tax contributions and $2,500 (adjusted for earnings) of elective deferrals is made to Employee T. Employer G uses the forfeiture correction method to correct the § 415(c) excess with respect to Employee U. Thus, the § 415(c) excess is deemed to consist solely of the nonelective contributions. Accordingly, Employee U's nonvested account balance is reduced by $300 (adjusted for earnings) which is placed in an unallocated account, similar to the suspense account described in § 1.415-6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). After correction, it is determined that the ADP and ACP tests for 1998 were satisfied.

Example 18:

Employer H maintains a 401(k) plan. The plan provides for nonelective employer contributions, matching contributions and elective deferrals. The plan provides for matching contributions that are equal to 100% of an employee's elective deferrals that do not exceed 8% of the employee's plan compensation for the plan year. For the 1998 limitation year, Employee V had § 415 compensation of $50,000, and, accordingly, a § 415(c)(1)(B) limit of $12,500. During that limitation year, the annual additions for Employee V totaled $15,000, consisting of $5,000 in elective deferrals, a $4,000 matching contribution (8% of $50,000), and a $6,000 nonelective employer contribution. Thus, the annual additions for Employee V exceeded the § 415(c) limit by $2,500.

Correction:

Employer H uses the SVP correction method to correct the § 415(c) excess with respect to Employee V (i.e., $2,500). Accordingly, $1,000 of the unmatched elective deferrals (adjusted for earnings) are distributed to Employee V. The remaining $1,500 excess is apportioned equally between the elective deferrals and the associated matching employer contributions, so Employee V's account balance is further reduced by distributing to Employee V $750 (adjusted for earnings) of the elective deferrals and forfeiting $750 (adjusted for earnings) of the associated employer matching contributions. The forfeited matching contributions are placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). After correction, it is determined that the ADP and ACP tests for 1998 were satisfied.

.05 *Other Overpayment Failures.*

(1) Correction of Overpayment. An Overpayment, other than one described in section 4.04(1) (relating to a § 415(b) excess) or section 4.04(2) (relating to a § 415(c) excess), may be corrected in accordance with this section 4.05. An Overpayment from a defined benefit plan is corrected in accordance with the rules in section 4.04(1). An Overpayment from a defined contribution plan is corrected in accordance with the rules in section 4.04(2)(a)(iii).

(2) Overpayment Defined. For purposes of this revenue procedure, an Overpayment is defined as a distribution to an employee or beneficiary that exceeds the employee's or beneficiary's benefit under the terms of the plan because of a failure to comply with plan terms that implement § 401(a)(17), 401(m) (but only with respect to the forfeiture of nonvested matching contributions that are excess aggregate contributions), 411(a)(3)(G), or 415. An Overpayment does not include a distribution of an Excess Amount described in section 3.06(2) (b), (c), (d), or (e).

.06 § 401(a)(17) Failures.

(1) Reduction of Account Balance Correction Method. The allocation of contributions or forfeitures under a defined contribution plan for a plan year on the basis of compensation in excess of the limit under § 401(a)(17) for the plan year may be corrected using the reduction of account balance correction method set forth in this paragraph. The account balance of an employee who received an allocation on the basis of compensation in excess of the § 401(a)(17) limit is reduced by this improperly allocated amount (adjusted for earnings). If the improperly allocated amount would have been allocated to other employees in the year of the failure if the failure had not occurred, then that amount (adjusted for earnings) is reallocated to those employees in accordance with the plan's allocation formula. If the improperly allocated amount would not have been allocated to other employees absent the failure, that amount (adjusted for earnings) is placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). For example, if a plan provides for a fixed level of employer contributions for each eligible employee, and the plan provides that forfeitures are used to reduce future employer contributions, the improperly allocated amount (adjusted for earnings) would be used to reduce future employer contributions. (See Example 19.) If a payment was made to an employee and that payment was attributable to an improperly allocated amount, then it is an Overpayment defined in section 4.05(2) that must be corrected (see section 4.05(1)).

(2) Example.

Example 19:

Employer J maintains a money purchase pension plan. Under the plan, an eligible employee is entitled to an employer contribution of 8% of the employee's compensation up to the § 401(a)(17) limit ($160,000 for 1998). During the 1998 plan year, an eligible employee, Employee W, inadvertently was credited with a contribution based on compensation above the § 401(a)(17) limit. Employee W's compensation for 1998 was $220,000. Employee W received a contribution of $17,600 for 1998 (8% of $220,000), rather than the contribution of $12,800 (8% of $160,000) provided by the plan for that year, resulting in an improper allocation of $4,800.

Correction:

The § 401(a)(17) failure is corrected using the reduction of account balance method by reducing Employee W's account balance by $4,800 (adjusted for earnings) and crediting that amount to an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s).

.07 *Correction by Amendment Under Walk-in CAP.*

(1) § 401(a)(17) Failures. (a) Contribution Correction Method. In addition to the reduction of account balance correction method under section 4.06, an employer may correct a § 401(a)(17) failure for a plan year under a defined contribution plan under the Walk-in Closing Agreement Program ("Walk-in CAP") (in accordance with the requirements of section 11 of Rev. Proc. 98–22) by using the contribution correction method set forth in this paragraph. The employer contributes an additional amount on behalf of each of the other employees (excluding each employee for whom there was a § 401(a)(17) failure) who received an allocation for the year of the failure, amending the plan (as necessary) to provide for the additional allocation. The amount contributed for an employee is equal to the employee's plan compensation for the year of the failure multiplied by a fraction, the numerator of which is the improperly allocated amount made on behalf of the employee with the largest improperly allocated amount, and the denominator of which is the limit under § 401(a)(17) applicable to the year of the failure. The resulting additional amount for each of the other employees is adjusted for earnings. (See Example 20.)

(b) Examples.

Example 20:

The facts are the same as in Example 19.

Correction:

Employer J corrects the failure under Walk-in CAP using the contribution correction method by (1) amending the plan to increase the contribution percentage for all eligible employees (other than Employee W) for the 1998 plan year and (2) contributing an additional amount (adjusted for earnings) for those employees for that plan year. To determine the increase in the plan's contribution percentage (and the additional amount contributed on behalf of each eligible employee), the improperly allocated amount ($4,800) is divided by the § 401(a)(17) limit for 1998 ($160,000). Accordingly, the plan is amended to increase the contribution percentage by 3 percentage points ($4,800/$160,000) from 8% to 11%. In addition, each eligible employee for the 1998 plan year (other than Employee W) receives an additional contribution of 3% multiplied by that employee's plan compensation for 1998. This additional contribution is adjusted for earnings.

(2) Hardship Distribution Failures. (a) Plan Amendment Correction Method. The Operational Failure of making hardship distributions to employees under a plan that does not provide for hardship distributions may be corrected under Walk-in CAP (in accordance with the requirements of section 11 of Rev. Proc. 98-22) using the plan amendment correction method set forth in this paragraph. The plan is amended retroactively to provide for the hardship distributions that were made available. This paragraph does not apply unless (i) the amendment satisfies § 401(a), and (ii) the plan as amended would have satisfied the qualification requirements of § 401(a) (including the requirements applicable to hardship distributions under § 401(k), if applicable) had the amendment been adopted when hard-

ship distributions were first made available. (See Example 21.)

(b) Example.

Example 21:

Employer K, a for-profit corporation, maintains a 401(k) plan. Although plan provisions in 1998 did not provide for hardship distributions, beginning in 1998 hardship distributions of amounts allowed to be distributed under § 401(k) were made currently and effectively available to all employees (within the meaning of § l.401(a)(4)–4). The standard used to determine hardship satisfied the deemed hardship distribution standards in § 1.401(k)–1(d)(2). Hardship distributions were made to a number of employees during the 1998 and 1999 plan years, creating an Operational Failure. The failure was discovered in 2000.

Correction:

Employer K corrects the failure through Walk-in CAP by adopting a plan amendment, effective January 1, 1998, to provide a hardship distribution option that satisfies the rules applicable to hardship distributions in § 1.401(k)–1(d)(2). The amendment provides that the hardship distribution option is available to all employees. Thus, the amendment satisfies § 401(a), and the plan as amended in 2000 would have satisfied § 401(a) (including § 1.401(a)(4)–4 and the requirements applicable to hardship distributions under § 401(k)) if the amendment had been adopted in 1998.

SECTION 5. EARNINGS ADJUSTMENT METHODS AND EXAMPLES

.01 *Earnings Adjustment Methods.* (1) In general. (a) Under section 6.02(3)(a) of Rev. Proc. 98–22, whenever the appropriate correction method for an Operational Failure in a defined contribution plan includes a corrective contribution or allocation that increases one or more employees' account balance (now or in the future), the contribution or allocation is adjusted for earnings and forfeitures. This section 5 provides earnings adjustment methods (but not forfeiture adjustment methods) that may be used by an employer to adjust a corrective contribution or allocation for earnings in a defined contribution plan. Consequently, these earnings adjustment methods may be used to determine the earnings adjustments for corrective contributions or allocations made under the correction methods in section 4 and under the SVP correction methods in Appendix A, in Rev. Proc. 98–22. If an earnings adjustment method in this section 5 is used to adjust a corrective contribution or allocation, that adjustment is treated as satisfying the earnings adjustment requirement of section 6.02(3)(a) of Rev. Proc. 98–22. Other earnings adjustment methods, different from those illustrated in this section 5, may also be appropriate for adjusting corrective contributions or allocations to reflect earnings.

(b) Under the earnings adjustment methods of this section 5, a corrective contribution or allocation that increases an employee's account balance is adjusted to reflect an "earnings amount" that is based on the earnings rate(s) (determined under section 5.01(3)) for the period of the failure (determined under section 5.01(2)). The earnings amount is allocated in accordance with section 5.01(4).

(c) The rule in section 6.02(4)(a) of Rev. Proc. 98–22 permitting reasonable estimates in certain circumstances applies for purposes of this section 5. For this purpose, a determination of earnings made in accordance with the rules of administrative convenience set forth in this section 5 is treated as a precise determination of earnings. Thus, if the probable difference between an approximate determination of earnings and a determination of earnings under this section 5 is insignificant and the administrative cost of a precise determination would significantly exceed the probable difference, reasonable estimates may be used in calculating the appropriate earnings.

(d) This section 5 does not apply to corrective distributions or corrective reductions in account balances. Thus, for example, while this section 5 applies in increasing the account balance of an improperly excluded employee to correct the exclusion of the employee under the reallocation correction method described in section 4.02(2)(a)(iii)(B), this section 5 does not apply in reducing the account balances of other employees under the reallocation correction method. (See section 4.02(2)(a)(iii)(C) for rules that apply to the earnings adjustments for such reductions.) In addition, this section 5 does not apply in determining earnings adjustments under the one-to-one correction method described in section 4.01(1)(b)(iii).

(2) Period of the Failure. (a) General Rule. For purposes of this section 5, the "period of the failure" is the period from the date that the failure began through the date of correction. For example, in the case of an improper forfeiture of an employee's account balance, the beginning of the period of the failure is the date as of which the account balance was improperly reduced.

(b) Special Rules for Beginning Date for Exclusion of Eligible Employees from Plan. (i) General Rule. In the case of an exclusion of an eligible employee from a plan contribution, the beginning of the period of the failure is the date on which contributions of the same type (e.g., elective deferrals, matching contributions, or discretionary nonelective employer contributions) were made for other employees for the year of the failure. In the case of an exclusion of an eligible employee from an allocation of a forfeiture, the beginning of the period of the failure is the date on which forfeitures were allocated to other employees for the year of the failure.

(ii) Exclusion from a 401(k) or (m) Plan. For administrative convenience, for purposes of calculating the earnings rate for corrective contributions for a plan year (or the portion of the plan year) during which an employee was improperly excluded from making periodic elective deferrals or employee after-tax contributions, or from receiving periodic matching contributions, the employer may treat the date on which the contributions would have been made as the midpoint of the plan year (or the midpoint of the portion of the plan year) for which the failure occurred. Alternatively, in this case, the employer may treat the date on which the contributions would have been made as the first date of the plan year (or the portion of the plan year) during which an employee was excluded, provided that the earnings rate used is one half of the earnings rate applicable under section 5.01(3) for the plan year (or the portion of the plan year) for which the failure occurred.

(3) Earnings Rate. (a) General Rule. For purposes of this section 5, the earnings rate generally is based on the investment results that would have applied to the corrective contribution or allocation if the failure had not occurred.

(b) Multiple Investment Funds. If a plan permits employees to direct the investment of account balances into more than one investment fund, the earnings rate is based on the rate applicable to the employee's investment choices for the period of the failure. In accordance with section 6.03(3)(a) of Rev. Proc. 98–22, for administrative convenience, if most of the employees for whom the corrective contribution or allocation is made are nonhighly compensated employees, the rate of return of the fund with the highest earnings rate under the plan for the period of the failure may be used to determine the earnings rate for all corrective contributions or allocations. If the employee had not made any applicable investment choices, the earnings rate may be based on the earnings rate under the plan as a whole (i.e., the average of the rates earned by all of the funds in the valuation periods during the period of the failure weighted by the portion of the plan assets invested in the various funds during the period of the failure).

(c) Other Simplifying Assumptions. For administrative convenience, the earnings rate applicable to the corrective contribution or allocation for a valuation period with respect to any investment fund may be assumed to be the actual earnings rate for the plan's investments in that fund during that valuation period. For example, the earnings rate may be determined without regard to any special investment provisions that vary according to the size of the fund. Further, the earnings rate applicable to the corrective contribution or allocation for a portion of a valuation period may be a pro rata portion of the earnings rate for the entire valuation period, unless the application of this rule would result in either a significant understatement or overstatement of the actual earnings during that portion of the valuation period.

(4) Allocation Methods. (a) In General. For purposes of this section 5, the earnings amount generally may be allocated in accordance with any of the methods set forth in this paragraph (4). The methods under paragraph (4)(c), (d), and (e) are intended to be particularly helpful where corrective contributions are made at dates between the plan's valuation dates.

(b) Plan Allocation Method. Under the plan allocation method, the earnings amount is allocated to account balances under the plan in accordance with the plan's method for allocating earnings as if the failure had not occurred. (See Example 22.)

(c) Specific Employee Allocation Method. Under the specific employee allocation method, the entire earnings amount is allocated solely to the account balance of the employee on whose behalf the corrective contribution or allocation is made (regardless of whether the plan's allocation method would have allocated the earnings solely to that employee). In determining the allocation of plan earnings for the valuation period during which the corrective contribution or allocation is made, the corrective contribution or allocation (including the earnings amount) is treated in the same manner as any other contribution under the plan on behalf of the employee during that valuation period. Alternatively, where the plan's allocation method does not allocate plan earnings for a valuation period to a contribution made during that valuation period, plan earnings for the valuation period during which the corrective contribution or allocation is made may be allocated as if that employee's account balance had been increased as of the last day of the prior valuation period by the corrective contribution or allocation, including only that portion of the earnings amount attributable to earnings through the last day of the prior valuation period. The employee's account balance is then further increased as of the last day of the valuation period during which the corrective contribution or allocation is made by that portion of the earnings amount attributable to earnings after the last day of the prior valuation period. (See Example 23.)

(d) Bifurcated Allocation Method. Under the bifurcated allocation method, the entire earnings amount for the valuation periods ending before the date the corrective contribution or allocation is made is allocated solely to the account balance of the employee on whose behalf the corrective contribution or allocation is made. The earnings amount for the valuation period during which the corrective contribution or allocation is made is allocated in accordance with the plan's method for allocating other earnings for that valuation period in accordance with section 5.01(4)(b). (See Example 24.)

(e) Current Period Allocation Method. Under the current period allocation method, the portion of the earnings amount attributable to the valuation period during which the period of the failure begins ("first partial valuation period") is allocated in the same manner as earnings for the valuation period during which the corrective contribution or allocation is made in accordance section 5.01(4)(b). The earnings for the subsequent full valuation periods ending before the beginning of the valuation period during which the corrective contribution or allocation is made are allocated solely to the employee for whom the required contribution should have been made. The earnings amount for the valuation period during which the corrective contribution or allocation is made ("second partial valuation period") is allocated in accordance with the plan's method for allocating other earnings for that valuation period in accordance with section 5.01(4)(b). (See Example 25.)

.02 Examples.

Example 22:

Employer L maintains a profit-sharing plan that provides only for nonelective contributions. The plan has a single investment fund. Under the plan, assets are valued annually (the last day of the plan year) and earnings for the year are allocated in proportion to account balances as of the last day of the prior year, after reduction for distributions during the current year but without regard to contributions received during the current year (the "prior year account balance"). Plan contributions for 1997 were made on March 31, 1998. On April 20, 2000 Employer L determines that an Operational Failure occurred for 1997 because Employee X was improperly excluded from the plan. Employer L decides to correct the failure by using the SVP correction method for the exclusion of an eligible employee from nonelective contributions in a profit-sharing plan. Under this method, Employer L determines that this failure is corrected by making a contribution on behalf of Employee X of $5,000 (adjusted for earnings). The earnings rate under the plan for 1998 was +20%. The earnings rate under the plan for 1999 was +10%. On May 15, 2000, when Employer L determines that a contribution to correct for the failure will be made on June 1, 2000, a reasonable estimate of the earnings rate under the plan from January 1, 2000 to June 1, 2000 is +12%.

Earnings Adjustment on the Corrective Contribution:

The $5,000 corrective contribution on behalf of Employee X is adjusted to reflect an earnings amount based on the earnings rates for the period of the failure (March 31, 1998 through June 1, 2000) and the earnings amount is allocated using the plan allocation method. Employer L determines that a pro rata simplifying assumption may be used to determine the earnings rate for the period from March 31, 1998 to December 31, 1998, because that rate does not significantly understate or overstate the actual earnings for that period. Accordingly, Employer L determines that the earnings rate for that period is 15% (9/12 of the plan's 20% earnings rate for the year). Thus, applicable earnings rates under the plan during the period of the failure are:

Time Periods	Earnings Rate
3/31/98 – 12/31/98 (First Partial Valuation Period)	+15%
1/1/99 – 12/31/99	+10%
1/1/00 – 6/1/00 (Second Partial Valuation Period)	+12%

If the $5,000 corrective contribution had been contributed for Employee X on March 31, 1998, (1) earnings for 1998 would have been increased by the amount of the earnings on the additional $5,000 contribution from March 31, 1998 through December 31, 1998 and would have been allocated as 1998 earnings in proportion to the prior year (December 31, 1997) account balances, (2) Employee X's account balance as of December 31, 1998 would have been increased by the additional $5,000 contribution, (3) earnings for 1999 would have been increased by the 1999 earnings on the additional $5,000 contribution (including 1998 earnings thereon) allocated in proportion to the prior year (December 31, 1998) account balances along with other 1999 earnings, and (4) earnings for 2000 would have been increased by the earnings on the additional $5,000 (including 1998 and 1999 earnings thereon) from January 1 to June 1, 2000 and would be allocated in proportion to the prior year (December 31, 1999) account balances along with other 2000 earnings. Accordingly, the $5,000 corrective contribution is adjusted to reflect an earnings amount of $2,084 ($5,000[(1.15)(1.10)(1.12)–1]) and the earnings amount is allocated to the account balances under the plan allocation method as follows:

(a) Each account balance that shared in the allocation of earnings for 1998 is increased, as of December 31, 1998, by its appropriate share of the earnings amount for 1998, $750 ($5,000(.15)).

(b) Employee X's account balance is increased, as of December 31, 1998, by $5,000.

(c) The resulting December 31, 1998 account balances will share in the 1999 earnings, including the $575 for 1999 earnings included in the corrective contribution ($5,750(.10)), to determine the account balances as of December 31, 1999. However, each account balance other than Employee X's account balance has already shared in the 1999 earnings, excluding the $575. Accordingly, Employee X's account balance as of December 31, 1999 will include $500 of the 1999 portion of the earnings amount based on the $5,000 corrective contribution allocated to Employee X's account balance as of December 31, 1998 ($5,000(.10)). Then each account balance that originally shared in the allocation of earnings for 1999 (i.e., excluding the $5,500 additions to Employee X's account balance) is increased by its appropriate share of the remaining 1999 portion of the earnings amount, $75.

(d) The resulting December 31, 1999 account balances (including the $5,500 additions to Employee X's account balance) will share in the 2000 portion of the earnings amount based on the estimated January 1, 2000 to June 1, 2000 earnings included in the corrective contribution equal to $759 ($6,325(.12)). (See Table 1.)

TABLE 1
CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

	Earnings Rate	Amount	Allocated to:
Corrective Contribution		$5,000	Employee X
First Partial Valuation Period Earnings	15%	750[1]	All 12/31/1997 Account Balances[4]
1999 Earnings	10%	575[2]	Employee X ($500)/ All 12/31/1998 Account Balances ($75)[4]
Second Partial Valuation Period Earnings	12%	759[3]	All 12/31/1999 Account Balances (including Employee X's $5,500)[4]
Total Amount Contributed		$7,084	

[1] $5,000 × 15%
[2] $5,750($5,000 + 750) × 10%
[3] $6,325($5,000 + 750 + 575) × 12%
[4] After reduction for distributions during the year for which earning are being determined but without regard to contributions received during the year for which earnings are being determined.

Example 23:

The facts are the same as in Example 22.

Earnings Adjustment on the Corrective Contribution:

The earnings amount on the corrective contribution is the same as in Example 22, but the earnings amount is allocated using the specific employee allocation method. Thus, the entire earnings amount for all periods through June 1, 2000 (i.e., $750 for March 31, 1998 to December 31, 1998, $575 for 1999, and $759 for January 1, 2000 to June 1, 2000) is allocated to Employee X. Accordingly, Employer L makes a contribution on June 1, 2000 to the plan of $7,084 ($5,000(1.15) (1.10)(1.12)). Employee X's account balance as of December 31, 2000 is increased by $7,084. Alternatively, Employee X's account balance as of December 31, 1999 is increased by $6,325 ($5,000(1.15)(1.10)), which shares in the allocation of earnings for 2000, and Employee X's account balance as of December 31, 2000 is increased by the remaining $759. (See Table 2.)

TABLE 2 CALCULATION AND ALLOCATION OF THE CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS			
	Earnings Rate	Amount	Allocated to:
Corrective Contribution		$5,000	Employee X
First Partial Valuation Period Earnings	15%	750[1]	Employee X
1999 Earnings	10%	575[2]	Employee X
Second Partial Valuation Period Earnings	12%	759[3]	Employee X
Total Amount Contributed		$7,084	

[1] $5,000 × 15%
[2] $5,750 ($5,000 + 750) × 10%
[3] $6,325 ($5,000 + 750 + 575) × 12%

Example 24:

The facts are the same as in Example 22.

Earnings Adjustment on the Corrective Contribution:

The earnings amount on the corrective contribution is the same as in Example 22, but the earnings amount is allocated using the bifurcated allocation method. Thus, the earnings for the first partial valuation period (March 31, 1998 to December 31, 1998) and the earnings for 1999 are allocated to Employee X. Accordingly, Employer L makes a contribution on June 1, 2000 to the plan of $7,084 ($5,000(1.15)(1.10)(1.12)). Employee X's account balance as of December 31, 1999 is increased by $6,325 ($5,000 (1.15)(1.10)); and the December 31, 1999 account balances of employees (including Employee X's increased account balance) will share in estimated January 1, 2000 to June 1, 2000 earnings on the corrective contribution equal to $759 ($6,325(.12)). (See Table 3.)

TABLE 3 CALCULATION AND ALLOCATION OF THE CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS			
	Earnings Rate	Amount	Allocated to:
Corrective Contribution		$5,000	Employee X
First Partial Valuation Period Earnings	15%	750[1]	Employee X
1999 Earnings	10%	575[2]	Employee X
Second Partial Valuation Period Earnings	12%	759[3]	12/31/99 Account Balances (including Employee X's $6,325)[4]
Total Amount Contributed		$7,084	

[1] $5,000 × 15%
[2] $5,750 ($5,000 + 750) × 10%
[3] $6,325 ($5,000 +750 + 575) × 12%
[4] After reduction for distributions during the 2000 year but without regard to contributions received during the 2000 year .

Example 25:

The facts are the same as in Example 22.

Earnings Adjustment on the Corrective Contribution:

The earnings amount on the corrective contribution is the same as in Example 22, but the earnings amount is allocated using the current period allocation method. Thus, the earnings for the first partial valuation period (March 31, 1998 to December 31, 1998) are allocated as 2000 earnings. Accordingly, Employer L makes a contribution on June 1, 2000 to the plan of $7,084 ($5,000 (1.15)(1.10) (1.12)). Employee X's account balance as of December 31, 1999 is increased by the sum of $5,500 ($5,000(1.10)) and the remaining 1999 earnings on the corrective contribution equal to $75 ($5,000(.15)(.10)). Further, both (1) the estimated March 31, 1998 to December 31, 1998 earnings on the corrective contribution equal to $750 ($5,000(.15)) and (2) the estimated January 1, 2000 to June 1, 2000 earnings on the corrective contribution equal to $759 ($6,325(.12)) are treated in the same manner as 2000 earnings by allocating these amounts to the December 31, 2000 account balances of employees in proportion to account balances as of December 31, 1999 (including Employee X's increased account balance). (See Table 4.) Thus, Employee X is allocated the earnings for the full valuation period during the period of the failure.

TABLE 4
CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

	Earnings Rate	Amount	Allocated to:
Corrective Contribution		$5,000	Employee X
First Partial Valuation Period Earnings	15%	750[1]	12/31/99 Account Balances (including Employee X's $5,575)[4]
1999 Earnings	10%	575[2]	Employee X
Second Partial Valuation Period Earnings	12%	759[3]	12/31/99 Account Balances (including Employee X's $5,575)[4]
Total Amount Contributed		$7,084	

[1] $5,000 × 15%
[2] $5,750($5,000 + 750) × 10%
[3] $6,325($5,000 + 750 + 575) × 12%
[4] After reduction for distributions during the year for which earnings are being determined but without regard to contributions received during the year for which earnings are being determined.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 98–22 clarified and supplemented. Rev. Proc. 98–22 is clarified and supplemented by this revenue procedure.

SECTION 7. EFFECTIVE DATE

The effective date of this revenue procedure is January 1, 2000. In addition, employers are permitted, at their option, to apply the provisions of this revenue procedure on or after March 9, 1998 (the release date of Rev. Proc. 98–22). Unless a plan sponsor applies the provisions of this revenue procedure earlier, this revenue procedure is effective:

(1) with respect to VCR and Walk-in CAP, for applications submitted on or after January 1, 2000;

(2) with respect to Audit CAP, for examinations begun on or after January 1, 2000; and

(3) with respect to APRSC, for failures for which correction is not complete before May 1, 2000.

SECTION 8. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1656.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are in sections 3.04 and 4.01–4.07. This information is required to enable the Office of Assistant Commissioner (Employee Plans and Exempt Organizations) of the Internal Revenue Service to make determinations regarding the issuance of certain closing agreements and to ascertain if plan participants have been notified of certain actions. This information can allow individual plans to continue to maintain their tax qualified status. As a result, favorable tax treatment of the benefits of the eligible employees is retained. The likely respondents are individuals, state or local governments, business or other for- profit institutions, nonprofit institutions, and small businesses or organizations.

The estimated total annual reporting and/or recordkeeping burden is 10,800 hours.

The estimated annual burden per respondent/recordkeeper varies from 2 to 12 hours, depending on individual circumstances, with an estimated average of 10.8 hours. The estimated number of respondents and/or recordkeepers is 1,000.

The estimated annual frequency of responses is occasionally.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Jeanne Royal Singley and Maxine Terry of the Employee Plans Division. For more information concerning this revenue procedure, call the Employee Plans Division's taxpayer assistance telephone service at (202) 622-6074/6075 (not toll-free numbers) between the hours of 1:30 and 3:30 p.m. Eastern Time, Monday through Thursday. Ms. Singley and Ms. Terry may be reached at (202) 622-6214 (also not a toll-free number).

Rev. Proc. 99–32

SUMMARY: This document contains a new revenue procedure that sets forth the Service's position regarding adjustments that may be made to conform the accounts of taxpayers to reflect allocations made under section 482 of the Internal Revenue Code.

SUPPLEMENTARY INFORMATION:

Background

In Announcement 99–1, 1999–2 I.R.B. 11, the Internal Revenue Service invited comment on a revision of Rev. Proc. 65–17, 1965–1 C.B. 833, on conforming a taxpayer's accounts to reflect a primary adjustment under section 482 of the Internal Revenue Code. The comments received and changes finally adopted in this revenue procedure are summarized below.

Explanation of Provisions

A. *Taxpayer-Initiated Primary Adjustments*

In furtherance of the overall goal of promoting upfront compliance with the arm's length standard, Announcement 99–1 proposed providing a mechanism for taxpayers to conform their accounts in connection with taxpayer-initiated (as well as Service-initiated) primary adjustments, without the Federal income tax consequences of the secondary adjustments that would otherwise result under section 482. Commentators welcomed this proposal and it is finally adopted in this revenue procedure. Accordingly, taxpayers may elect, by filing a statement with their Federal income their tax returns, to apply revenue procedure treatment for taxpayer-initiated upward and downward adjustments of taxable income pursuant to section 1.482–1(a)(3) of the Treasury regulations, in connection with inbound, outbound, and certain foreign-to-foreign controlled transactions. Election of revenue procedure treatment through such a statement shall be binding on the taxpayer.

B. *Offsets*

Announcement 99–1 proposed eliminating dividend offsets and making account treatment the sole means to repatriate the cash attributable to a primary adjustment, without the Federal income tax consequences of secondary adjustments. Some commentators supported this proposal on the ground that dividend paying policies are independent of transfer pricing. Other commentators, however, expressed the view that elimination of dividend offsets would discourage current repatriation of earnings, prolong transfer pricing disputes, and pose problems when payment of a form of income is restricted under foreign law. Others suggested that permitting offsets in connection with taxpayer-initiated adjustments would be consistent with upfront compliance with the arm's length standard.

In response to these comments, this revenue procedure allows taxpayers to offset accounts by distributions, including those that would otherwise be dividends, in the same year as that to which a taxpayer-initiated primary adjustment relates, provided the offset treatment is claimed on a timely-filed income tax return (including extensions). In addition, offsets may be claimed for distributions in the year in which a return is filed reporting a taxpayer-initiated adjustment or in the year a closing agreement is entered into in connection with a Service-initiated adjustment. Offsets are also permitted by means of entries offsetting bona fide debts and capital contributions. No offsets are allowed with respect to a year for which an income tax return has already been filed, except for pre-effective date years as described below. Offsets are treated as prepayments of the interest and principal of an account established under the revenue procedure for all Federal income tax purposes, regardless of their characterization under foreign law.

In the Service's view, these changes are consistent with the overall goal of upfront compliance with the arm's length standard and reduce any disincentive to repatriate earnings. Moreover, they improve administrability by dispensing with the need to reverse tax effects reported on prior income tax returns, as was required with the dividend offset pursuant to Rev. Proc. 65–17.

The Service recognizes that a domestic subsidiary of a foreign parent may claim an offset pursuant to this revenue procedure by reason of a distribution as to which the subsidiary withheld tax in accordance with its obligations pursuant to section 1442 of the Code. In such a case, the Service anticipates that the foreign parent will be able to file an income tax return to obtain a refund of such withholding tax.

The Service intends that offset treatment pursuant to this revenue procedure shall be the exclusive means of addressing the situations in which payments of certain forms of income are restricted under foreign law that are described in Example 2 and Example 3 of section 1.482–1(h)(2)(v) of the Treasury regulations.

C. *Effective Date and Transitional Treatment*

Announcement 99–1 proposed that the revised revenue procedure be prospectively effective for taxable years beginning after its publication. Commentators suggested that liberal transitional rules be provided for application of revenue procedure treatment in connection with taxpayer-initiated adjustments for pre-effective date taxable years.

In response to these comments, the final revised revenue procedure published in this document provides that for taxable years prior to the taxable year that includes the date of publication, taxpayers shall be permitted to use a reasonable interpretation of the principles of Rev. Proc. 65–17 for purposes of conforming their accounts to reflect a taxpayer-initiated primary adjustment. The Service considers an interpretation that applies the final revised revenue procedure or its general principles to be such a reasonable interpretation of Rev. Proc. 65–17. The Service also considers that a reasonable interpretation would include the permission of a taxpayer-initiated offset by reason of a distribution reported as a dividend on a prior income tax return for the taxable year to which the primary adjustment relates, provided the subsequent treatment reverses any previously claimed tax effects associated with such dividend in accordance with the principles of section 4.01 of Rev. Proc. 65–17.

For taxable years that include the date of publication of this revenue procedure, a taxpayer may elect to apply all of the provisions of this revenue procedure. Otherwise, Rev. Proc. 65–17 applies for such taxable years in accordance with its terms. In such cases, revenue procedure treatment for taxpayer-initiated adjustments will necessitate a closing agreement with the Service.

D. *Penalty Condition*

Announcement 99–1 proposed to substitute inapplicability of any penalty under section 6662(e), for absence of a principal tax avoidance purpose required under Rev. Proc. 65–17, as the condition for revenue procedure treatment. Commentators criticized the requirement of any condition for various reasons, including that such condition would inappropriately expand the section 6662(e) penalty and may yield apparently arbitrary results. Other commentators suggested that the determination of the inapplicability of the penalty was problematic in the case of a taxpayer-initiated adjustment.

This revenue procedure removes the penalty condition in the case of taxpayer-initiated adjustments, but retains the condition for Service-initiated adjustments, including such adjustments as result from examination of taxpayer-initiated adjustments. The condition is neither an expansion of the penalty, nor arbitrary, but, rather, it is a reasonable tax administration restriction on availability of the revenue procedure treatment. In the Service's view the penalty condition of this revenue procedure is more objective than absence of a principal tax avoidance purpose under Rev. Proc. 65–17 and, moreover, is consistent with the goal of upfront compliance.

E. *Other Changes and Clarifications*

As proposed by Announcement 99–1, the revenue procedure clarifies that a foreign tax credit shall be allowed for any foreign withholding tax with respect to the repayment of the principal or interest of the account to the extent and subject to the limitations provided under section 901 of the Code. The amount of any payment or prepayment of an account established under the revenue procedure is considered to include the amount of such foreign withholding tax. The revenue procedure does not adopt comments that allowance of a section 901 credit for a foreign withholding tax should be without regard to whether a taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures. This is a requirement under the applicable regulations. Treas. Reg. § 1.901–2(e)(5).

Persons eligible for revenue procedure treatment are limited to "United States taxpayers," i.e., either a domestic corporation or a foreign corporation that is, or is treated as, engaged in a trade or business within the United States. Controlled transactions between a controlled foreign corporation of a domestic corporation and a foreign related corporation are also eligible for treatment under the revenue procedure. Transactions with noncorporate persons, for example, a transaction between a partnership and its controlling corporate partner, are not covered by the revenue procedure, but will be the subject of further study by the Service.

Accounts under the revenue procedure are set up, and offsets are permitted, between the related corporation and the United States taxpayer, or any member of its affiliated group. See Rev. Proc. 70–23, 1970–2 C.B. 505, and Rev. Proc. 71–35, 1971–2 C.B. 573, both superseded by this revenue procedure. The revenue procedure clarifies application of the safe harbor interest rates in the case of interest on accounts. Where an account is paid in the form of term debt, such debt will be considered a new obligation commencing with a new term; however, payment by means of term debt shall be respected only to the extent the debt qualifies in substance as bona fide debt under applicable debt-equity rules. The revenue procedure provides that interest on accounts is includible in the income of the obligee on the accrual basis regardless of the obligee's method of accounting. See Rev. Proc. 72–48, 1972–2 C.B. 829, superseded by this revenue procedure. Account interest is deductible by the obligor, but subject to applicable limitations including sections 163(e)(3) and 267(a)(3) of the Code. Rules are prescribed for determining the currency in which the principal and interest of an account must be denominated, which generally will be the U.S. dollar.

Other conforming changes are made to incorporate the provisions of other various progeny of Rev. Proc. 65–17 that are superseded by this revenue procedure. Coordination of revenue procedure treatment and the competent authority process and the advance pricing agreement program will be considered in connection with the revision and updating of the revenue procedures governing those processes. See generally Rev. Proc. 96–13, 1996–1 C.B. 616; Rev. Proc. 96–14, 1996–1 C.B. 626; and Rev. Proc. 96–53, 1996–2 C.B. 375.

* * * * *

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also, Part I, section 482)

Rev. Proc. 99–32

SECTION 1. PURPOSE

Pursuant to section 1.482–1(g)(3) of the Income Tax Regulations, this revenue procedure prescribes the applicable procedures for the repatriation of cash by a United States taxpayer via an interest-bearing account receivable or payable (the "account") in an amount corresponding to the amount allocated to, or from, such taxpayer under section 482 of the Internal Revenue Code (the "Code") from, or to, a related person with respect to a controlled transaction. Additionally, circumstances are prescribed in which a United States taxpayer may treat an account as offset (the "offset") in whole or part by the amount of a bona fide debt, distribution, or capital contribution between the taxpayer and such related person. Under this revenue procedure, taxpayers whose taxable income has been adjusted under section 482 of the Code are generally permitted to make certain adjustments to conform their accounts to reflect the section 482 allocation. The conditions for treatment under this revenue procedure are set forth in section 3, the adjustments to be made or allowed are described in section 4 (for Internal Revenue Service as well as taxpayer-initiated adjustments), and the prescribed procedures are set forth in section 5.

SEC. 2. BACKGROUND AND SCOPE

Section 482 of the Code gives the Internal Revenue Service authority to "distribute, apportion or allocate gross income, deductions, credits, or allowances" among certain related organizations, trades or businesses if it "determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income" of any such entity. Absent a United States taxpayer's election of treatment under this revenue procedure, an adjustment under section 482 (the "primary adjustment") entails secondary adjustments to conform the taxpayer's accounts to reflect the primary adjustment. These secondary adjustments may result in adverse tax consequences to the taxpayer. For example, an allocation of income under section 482 from a foreign parent corporation to its domestic subsidiary corporation would entail a deemed distribution from the domestic subsidiary to its foreign parent in an amount equal to the primary adjustment in the year for which the allocation is made. The deemed distribution would be treated as dividend income to the foreign parent to the extent of the earnings and profits of the domestic subsidiary, as recomputed after taking into account the primary adjustment. Under section 881 of the Code, the foreign parent would be subject to a 30-percent tax liability (as reduced by any applicable income tax treaty), and under section 1442 of the Code, the domestic subsidiary would be a withholding agent required to withhold the tax. See Rev. Rul. 82–80, 1982–1 C.B. 89; Treas. Reg. § 1.1441–2(e)(2). This revenue procedure allows the United States taxpayer to repatriate the cash attributable to a primary adjustment via an account without the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment.

Additionally, section 1.482–1(a)(3) of the Income Tax Regulations permits a controlled taxpayer to report an arm's length result for controlled transactions based upon prices different from those actually charged. If the adjustment results in an increase in taxable income, the increased income may be reported by the taxpayer at any time. If the adjustment results in a decrease in taxable income (after appropriate accounting for section 1059A of the Code), the arm's length result may be reported on a timely filed return (including extensions). A United States taxpayer can avail itself of the treatment provided by this revenue procedure to mitigate the Federal income tax consequences of the secondary adjustments that would otherwise result from the taxpayer's "self-initiated" primary adjustment. In the case of a taxpayer-initiated adjustment, a United States taxpayer may, in accordance with section 4.02 of this revenue procedure, use an offset in combination with an account to effectuate the repatriation of the cash attributable to the primary adjustment without the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment. The United States taxpayer is bound by its election of treatment under the revenue procedure. The taxpayer-initiated adjustment for the treatment provided under the revenue procedure will be subject to review and adjustment, and to possible imposition of the section 6662(e) or (h) penalty, by the Service upon examination.

This revenue procedure applies in situations where an adjustment is made under section 482 of the Code, as well as to Service-initiated adjustments made under sections 61 or 162 of the Code, provided the adjustment could have been made under section 482 of the Code. All references in this revenue procedure to section 482 of the Code will be deemed to include sections 61 and 162 of the Code, except when the context or express language indicates or provides otherwise.

Any reference in this revenue procedure to an increase or decrease in, or an adjustment of, taxable income shall also be deemed a reference, in an appropriate case, to a reduction or increase in, or an adjustment of, a taxpayer's loss.

Any reference in this revenue procedure to the Service shall be deemed a reference to the office within the Service that has jurisdiction over the Federal income tax return filed for the taxable year for which the primary adjustment is made.

For purposes of this revenue procedure, a "United States taxpayer" is a domestic corporation, or a foreign corporation that is, or is treated as, engaged in trade or business within the United States.

For purposes of this revenue procedure, an increase or decrease, or an adjustment of, the taxable income of a United States taxpayer that is a domestic corporation pursuant to section 482 of the Code shall be deemed to include an allocation of an amount to, or from, a related person (being a corporation as defined in section 7701(a)(3) of the Code), from, or to, a foreign corporation that is a controlled foreign corporation within the meaning of section 957 of the Code solely by reason of ownership of such foreign corporation's stock by such domestic corporation (or any member of the affiliated group within the meaning of section 1504(a) of the Code in which such domestic corporation is included) with respect to a controlled transaction. In the latter circumstances, the parties to any account established under section 4.01 shall be such controlled foreign corporation and such related person, and for purposes of section 4.01(2) the requirement to accrue and include, or deduct, interest in, or from, taxable income shall mean accounting for such interest for all Federal income tax purposes that may affect the determination of the taxable income or tax liability of such domestic corporation, including, for example, the computation of earnings and profits, subpart F income, and the foreign tax credit provided under section 901 of the Code.

Treatment under this revenue procedure shall not be denied solely by reason of the fact a corporation under State law is in existence for the purpose of winding up its affairs, where such corporation, subsequent to its liquidation, was a corporation from, or to, which an amount was allocated pursuant to section 482 of the Code.

SEC. 3. CONDITIONS FOR TREATMENT UNDER THIS REVENUE PROCEDURE

A United States taxpayer described in section 5 shall qualify for the treatment provided in this revenue procedure only if it satisfies the conditions described in this section 3.

.01 A United States taxpayer described in section 5.01 shall qualify for the treatment provided in this revenue procedure if the taxable income of such United States taxpayer is adjusted by the Internal Revenue Service under section 482 and no penalty under section 6662(e)(1)(B) or (h) of the Code on account of such primary adjustment is asserted and, if challenged, finally sustained. In the case of an adjustment under section 61 or 162, this condition will be deemed to be satisfied if no penalty could have been sustained under section 6662(e)(1)(B) or (h) on account of the adjustment that could have been made under section 482.

.02 A United States taxpayer described in section 5.02 shall qualify for the treatment provided in this revenue procedure, provided that the taxpayer shall be bound by its election of such treatment.

.03 A United States taxpayer shall not qualify under sections 3.01 or 3.02 for the treatment provided in this revenue procedure if any part of any underpayment of tax by such taxpayer for the taxable year involved in the section 482 allocation is due to fraud.

SEC. 4. ADJUSTMENTS TO BE MADE OR ALLOWED

.01 *Account, interest, currency, and payment.* If a United States taxpayer qualifying under section 3 complies with the requirements of section 5, such taxpayer (or any member of the affiliated group within the meaning of section 1504(a) of the Code in which such taxpayer is included) shall be permitted to establish an interest-bearing account receivable from, or payable to, the related person (being a corporation as defined in section 7701(a)(3) of the Code) from, or to, whom the section 482 allocation is made with respect to a controlled transaction in an amount equal to the primary adjustment for each of the years in which an allocation is made. The account may be established and paid in accordance with this revenue procedure without the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment. The account shall:

(1) be deemed to have been created as of the last day of the taxpayer's taxable year for which the primary adjustment is made;

(2) bear interest at an arm's length rate, computed in the manner provided in section 1.482–2(a)(2) of the regulations, from the day after the date the account is deemed to have been created to the date of payment. For purposes of section 1.482–2(a)(2)(iii), where applicable, the account shall be considered to be a loan or advance having a term extending from the day after the date the account is deemed to have been created through the expiration of the 90-day period required in section 5. The interest so computed shall be accrued and included by the obligee in taxable income for each taxable year during which the account is deemed outstanding, regardless of whether the obligee uses the cash receipts and disbursements method of accounting or the accrual method of accounting. The interest so computed shall be accrued and deducted (subject to applicable limitations) by the obligor from taxable income for each taxable year during which the account is deemed outstanding;

(3) be expressed, both as to principal and interest, in the functional currency of a qualified business unit, as defined in section 1.989(a)–1 of the regulations, through which the controlled transaction was carried out, if the residence of such qualified business unit, as defined in section 988(a)(3)(B)(ii), is the United States. If the residence of both of the qualified business units through which the controlled transaction was carried out is the United States, then the account shall be expressed, both as to principal and interest, in the functional currency of such U.S. resident qualified business unit of the obligee. If the residence of both of the qualified business units through which the controlled transaction was carried out is a country other than the United States, then the account shall be expressed, both as to principal and interest, in the functional currency of such non-U.S. resident qualified business unit of the corporation that is a domestic corporation, or if both corporations are domestic corporations, or neither corporation is a domestic corporation, then in the functional currency of such non-U.S. resident qualified business unit of the obligee;

(4) be paid within the 90-day period required in section 5, or treated as prepaid by offset prior to that time as provided in section 4.02. Payment within the 90-day period must be in the form of money, a written debt obligation payable at a fixed date and bearing interest at an arm's length rate determined in the manner provided in section 1.482–2(a)(2) of the regulations, or an accounting entry offsetting such account against an existing bona fide debt between the United States taxpayer (or member of its affiliated group) and the related person. Any such payment within the 90-day period, and any such prepayment prior to that time pursuant to section 4.02, shall be treated as a payment of the account for all Federal income tax purposes, regardless of its characterization under foreign law. For example, to the extent that an account is offset pursuant to section 4.02, by a distribution that would otherwise have constituted a dividend, such distribution shall cease to qualify as a dividend under section 316 of the Code or as a dividend for any Federal income tax purpose; for instance, no foreign tax shall be deemed to have been paid with respect thereto under section 902 of the Code for the purpose of the credit allowed under section 901 of the Code and no dividend received deduction shall be allowed with respect thereto under sections 241 through 247 of the Code. An amount includible in income under section 551 or 951 of the Code shall not be considered a distribution for purposes of this paragraph or section 4.02.

A foreign tax credit shall be allowed for any foreign withholding tax with respect to the repayment of the principal or interest of the account to the extent and subject to the limitations provided under section 901 of the Code. See Treas. Reg. §§ 1.901–2(e)(5) and 1.904–6(a)(1)(iv).

.02 *Offset.* All or part of the interest and principal of an account may be treated as prepaid prior to the beginning of the 90-day period required in section 5 to the extent of an accounting entry offsetting such account against a bona fide debt between the United States taxpayer (or member of its affiliated group) and the related person, or to the extent of any distribution of property or contribution to capital between such parties, where the offsetting entry, the distribution, or the capital contribution occurs during the taxable year in which occurs the execution of the closing agreement on behalf of the Commissioner (in a case under section 5.01), or during the taxable year in which occurs the date on which the United States taxpayer files the return reporting the primary adjustment (in a case under section 5.02), or during the taxable year for which the section 482 allocation is made (in a case under section 5.02, but subject to the provisions stated in the next two sentences). For purposes of this revenue procedure, any offset of the account by reason of such a bona fide debt, distribution, or capital contribution during the taxable year for which the section 482 allocation is made shall be treated as a prepayment of the account made as of the beginning of the day after the date the account is deemed to have been created. No untimely or amended returns will be permitted to claim offset treatment by reason of such a bona fide debt, distribution, or capital contribution during the taxable year for which the section 482 allocation is made.

.03 *Primary adjustment not affected.* A United States taxpayer's election to avail itself of the provisions of this revenue procedure shall in no way affect the primary adjustment under section 482 of the Code. Such election shall, however, affect the taxpayer's taxable income and credits to the extent indicated by section 4.01 and eliminate the collateral effects of secondary adjustments, such as those described in section 2.

SEC. 5. PROCEDURES TO BE FOLLOWED

.01 *Cases pending with the Internal Revenue Service.*

(1) If a United States taxpayer whose taxable income has been adjusted by the Internal Revenue Service pursuant to section 482 of the Code desires to avail itself of the treatment provided in section 4, it must file a request in writing with the Service before closing action is taken on the primary adjustment. For purposes of this revenue procedure, the first occurring of the following shall constitute "closing action":

(a) Execution and acceptance of Form 870-AD, Offer of Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and of Acceptance of Overassessment, or execution of a closing agreement relative to the section 482 allocation;

(b) Stipulation of a section 482 allocation in the Tax Court of the United States;

(c) Expiration of the statute of limitations on assessments for the year to which the allocation applies;

(d) Final determination of tax liability for the year to which the allocation relates by offer-in-compromise, closing agreement, or court action.

(2) The request shall be signed by a person having the authority to sign the United States taxpayer's Federal income tax returns, and shall contain the following:

(a) A statement that the taxpayer desires the treatment provided by section 4 of this revenue procedure and the years for which the treatment is requested;

(b) A description of the arrangements or transactions, or the terms thereof, which gave rise to the primary adjustment;

(c) An offer to enter into a closing agreement under section 7121 of the Code as provided in section 5.01(4).

(3) The Service will determine whether the United States taxpayer qualifies for the requested treatment and inform the taxpayer of its decision.

(4) If the Service concludes that section 4 of this revenue procedure properly applies, and if the amount of the primary adjustment has been agreed upon, the United States taxpayer will be requested to enter into a closing agreement under section 7121 of the Code, establishing for each year involved:

(a) The amount of the primary adjustment;

(b) The amount and currency of, and parties to, the account which the taxpayer elects to establish under section 4.01;

(c) The amount of the interest on the account includible in income, or deductible, pursuant to section 4.01;

(d) The amount of any foreign tax credit that the taxpayer will claim under section 901 of the Code with respect to payment of the principal or interest on an account established pursuant to section 4.01;

(e) The manner of payment of the account pursuant to sections 4.01 and 4.02 and the taxpayer's right to receive or make such payment free of the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment, provided the payment of the balance of the account, after taking into consideration any prepayment pursuant to section 4.02 is made within 90 days after execution of the closing agreement on behalf of the Commissioner.

.02 *Cases of a United States taxpayer reporting an adjustment pursuant to section 1.482–1(a)(3) of the regulations.* If a United States taxpayer that has increased or decreased its taxable income pursuant to section 482 and section 1.482–1(a)(3) of the regulations desires to avail itself of the treatment provided in section 4, it must file a statement with its Federal income tax return reporting the primary adjustment:

(1) A statement that the taxpayer desires the treatment provided by section 4 of this revenue procedure for the years indicated and acknowledges that it is bound by its election of such treatment;

(2) A description of the arrangements or transactions, or the terms thereof, which gave rise to the primary adjustment;

(3) The amount of the primary adjustment;

(4) The amount and nature of any correlative allocation to each related person from, or to, whom the section 482 allocation is made with respect to a controlled transaction, and the corresponding account and treatment thereof by each such related person that is consistent with the treatment applied under this revenue procedure;

(5) The amount and currency of, and parties to, the account which the taxpayer elects to establish under section 4.01;

(6) The amount of interest on the account includible in income, or deductible, pursuant to section 4.01 and the years of such inclusion or deduction;

(7) The amount of any foreign tax credit that the taxpayer will claim under section

901 of the Code with respect to payment of the principal or interest on an account established pursuant to section 4.01;

(8) The manner of payment of the account pursuant to sections 4.01 and 4.02, which shall be free of the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment, provided the payment of the balance of the account, after taking into consideration any prepayment pursuant to section 4.02, is made within 90 days of the date on which the taxpayer files the return reporting the primary adjustment, and a statement that any such payment within the 90-day period, and any such prepayment prior to that time, shall be treated as a payment of the account for all Federal income tax purposes, regardless of its characterization under foreign law.

.03 *Cases pending before the Tax Court of the United States.* If a case reaches trial status in the Tax Court and it is determined that the United States taxpayer is entitled to the treatment provided in section 4, the parties may stipulate or otherwise arrange with the Court so that any adjustment in tax for the years before the Court will reflect the application of section 4, provided the taxpayer executes the required closing agreement.

.04 *Cases within the jurisdiction of the Department of Justice.* If a United States taxpayer files with the Service a request for treatment under section 4, with respect to a case within the jurisdiction of the Department of Justice, the Service, through its Chief Counsel, will recommend to the Department of Justice the action to be taken with respect to the taxpayer's request.

SEC. 6. EFFECTIVE DATE

.01 *In general.* This revenue procedure is effective for taxable years beginning after August 23, 1999.

.02 *Election for taxable year including August 23, 1999.* A United States taxpayer may elect to apply all of the provisions of this revenue procedure on its U.S. income tax return for its taxable year including August 23, 1999.

.03 *Taxpayer-initiated adjustments for taxable years prior to the taxable year including August 23, 1999.* A United States taxpayer that increased or decreased its taxable income pursuant to section 482 and section 1.482–1(a)(3) for a taxable year prior to the taxable year including August 23, 1999, shall be permitted to apply the principles of Rev. Proc. 65-17, 1965–1 C.B. 833, and its progeny, in accordance with any reasonable interpretation thereof for purposes of conforming accounts to reflect the taxpayer-initiated primary adjustment. The Service considers an interpretation that applies the final revised revenue procedure published in this document or its general principles to be such a reasonable interpretation of Rev. Proc. 65–17.

SEC. 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 65–17, 1965–1 C.B. 833, as amended by Rev. Proc. 65–17 (Amend. I), 1966–2 C.B. 1211 and Rev. Proc. 65–17 (Amend. II), 1974–1 C.B. 411, is superseded. Rev. Proc. 65–31, 1965–2 C.B. 1024, Rev. Proc. 70–23, 1970–2 C.B. 505, Rev. Proc. 71–35, 1971–2 C.B. 573, Rev. Proc. 72–22, 1972–1 C.B. 747, Rev. Proc. 72–46, 1972–2 C.B. 827, Rev. Proc. 72–48, 1972–2 C.B. 829, Rev. Proc. 72–53, 1972–2 C.B. 833 and Rev. Rul. 82–80, 1982–1 C.B. 89, are superseded. The references to Rev. Proc. 65–17 in Rev. Proc. 68–16, 1968–1 C.B. 770, Rev. Proc. 89–8, 1989–1 C.B. 778, Rev. Proc. 96–13, 1996–1 C.B. 616, Rev. Proc. 96–14, 1996–1 C.B. 626, and Rev. Proc. 96–53, 1996–2 C.B. 375, shall be treated as references to this revenue procedure.

SEC. 8. DRAFTING INFORMATION

The principal author of this Revenue Procedure is J. Peter Luedtke of the Office of the Associate Chief Counsel (International). For further information on this revenue procedure, contact J. Peter Luedtke at 202-874-1490 (not a toll-free call) or write to CC:INTL:Br6, Room 3319, 950 L'Enfant Plaza South, SW, Washington, DC 20024.

SEC. 9. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1657.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is in section 5. This information is required to determine whether a United States taxpayer that has made a primary adjustment under section 482 of the Code will be permitted to make certain adjustments to conform their accounts to reflect the section 482 allocation. The collections of information are required for a United States taxpayer to obtain the Commissioner's permission to repatriate the cash attributable to a primary adjustment via an account without the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment. The likely respondents are businesses or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 1,620 hours.

The estimated annual burden per respondent/recordkeeper varies from 8 hours to 10 hours depending on individual circumstances, with an estimated average of 9 hours. The estimated number of respondents and/or recordkeepers is 180.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, section 42; 1.42-14.)

Rev. Proc. 99–33

SECTION 1. PURPOSE

This revenue procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under § 42(h)(3)(D) of the Internal Revenue Code for calendar year 1999.

SECTION 2. BACKGROUND

Rev. Proc. 92–31, 1992–1 C.B. 775, provides guidance to state housing credit agencies of qualified states on the procedure for requesting an allocation of unused housing credit carryovers under § 42(h)(3)(D). Section 4.06 of Rev. Proc. 92–31 provides that the Internal Revenue Service will publish in the Internal Revenue Bulletin the amount of unused housing credit carryovers allocated to qualified states for a calendar year from a national pool of unused credit authority (the National Pool). This revenue procedure publishes these amounts for calendar year 1999.

SECTION 3. PROCEDURE

The unused housing credit carryover amount allocated from the National Pool by the Secretary to each qualified state for calendar year 1999 is as follows:

Qualified State	*Amount Allocated*
Alabama	$12,062
California	90,540
Connecticut	9,075
Delaware	2,061
Florida	41,342
Georgia	21,181
Idaho	3,405
Illinois	33,385
Indiana	16,350
Iowa	7,934
Kansas	7,287
Kentucky	10,911
Maryland	14,232
Massachusetts	17,038
Michigan	27,210
Minnesota	13,097
Missouri	15,074
Nebraska	4,608
Nevada	4,842
New Hampshire	3,285
New Jersey	22,492
New York	50,375
North Dakota	1,769
Ohio	31,069
Oklahoma	9,276
Oregon	9,096
Pennsylvania	33,264
Puerto Rico	9,762
Rhode Island	2,740
South Carolina	10,632
Tennessee	15,052
Texas	54,766
Utah	5,820
Vermont	1,638
Virginia	18,823
Washington	15,769
West Virginia	5,020

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for allocations of housing credit dollar amounts attributable to the National Pool component of a qualified state's housing credit ceiling for calendar year 1999.

DRAFTING INFORMATION

The principal author of this revenue procedure is Christopher J. Wilson of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Mr. Wilson on (202) 622-3040 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross Reference to Temporary Regulations and Notice of Public Hearing

Inbound Grantor Trusts With Foreign Grantors

REG–252487–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross reference to temporary regulations.

SUMMARY: The IRS is proposing regulations relating to the definition of the term grantor for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code. The text of temporary regulations published in T.D. 8831, on page 264, also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by October 12, 1999. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for November 2, 1999, at 10 a.m. must be submitted by October 12, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–252487–96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–252487–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, James A. Quinn, (202) 622-3060; concerning submissions and the hearing, Guy R. Traynor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in T.D. 8831, on page 264, amends the Income Tax Regulations (26 CFR part 1) relating to section 671. The temporary regulations contain rules relating to the definition of grantor for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 2, 1999, at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by October 12, 1999, and submit an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by October 12, 1999.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is James A. Quinn of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.671–2, paragraph (e) is revised to read as follows:

§1.671–2 Applicable principles.

* * * * *

(e) [The text of this proposed paragraph (e) is the same as the text of §1.671–2T(e) published in T.D. 8831.]

John M. Dalrymple,
Acting Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 5, 1999, 2:09 p.m., and published in the issue of the Federal Register for August 10, 1999, 64 F.R. 43323)

Notice of Proposed Rulemaking and Notice of Public Hearing

Capital Gains, Partnership, Subchapter S, and Trust Provisions

REG–106527–98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to sales or exchanges of interests in partnerships, S corporations, and trusts. The proposed regulations interpret the look-through provisions of section 1(h), added by section 311 of the Taxpayer Relief Act of 1997 and amended by sections 5001 and 6005(d) of the Internal Revenue Service Restructuring and Reform Act of 1998, and explain the rules relating to the division of the holding period of a partnership interest. The proposed regulations affect partnerships, partners, S corporations, S corporation shareholders, trusts, and trust beneficiaries.

DATES: Written comments must be received by November 8, 1999. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for November 18, 1999, must be received by October 28, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–106527–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–106527–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing will be held in room 3411, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jeanne Sullivan (202) 622-3050; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita VanDyke (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the **Office of Management and Budget** for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

Comments on the collections of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **IRS,** Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collections of information should be received by October 8, 1999. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the IRS, including whether the collections will have a practical utility;

The accuracy of the estimated burden associated with the proposed collections of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in these proposed regulations are in §1.1(h)–1(e). This information is required by the IRS to implement section 311 of the Taxpayer Relief Act of 1997, as amended by the Internal Revenue Service Restructuring and Reform Act of 1998. The collections of information are required to provide information to the IRS regarding the capital gain attributable to collectibles and section 1250 property held by a partnership when a partner sells or exchanges an interest in that partnership and the capital gain attributable to collectibles when a shareholder sells or exchanges an interest in an S corporation or a trust beneficiary sells or exchanges an interest in a trust. This information will be used to verify compliance with section 1(h) and to determine that the tax on capital gains has been computed correctly. The collection of information is mandatory. The likely respondents are individuals and businesses.

Respondent taxpayers provide information by attaching a statement to the appropriate tax return. The burden for this requirement is reflected in the burden estimates for: Form 1040, U.S. Individual Income Tax Return; Form 1065, U.S. Partnership Return of Income; Form 1041, U.S. Income Tax Return for Estates and Trusts; and Form 1120S, U.S. Income Tax Return for an S Corporation. The estimated burden of information collection for the statement required is 10 minutes.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to taxation of capital gains in the case of sales or exchanges of interests in partnerships, S corporations, and trusts. The Taxpayer Relief Act of 1997, Public Law 105–34, 111 Stat. 788, 831 (1997 Act), amended section 1(h) of the Internal Revenue Code to reduce the maximum statutory tax rates for long-term capital gains of individuals in general. Certain technical corrections and other amendments to section 1(h) were enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206, 112 Stat. 685, 787, 800 (1998 Act).

Section 1(h) provides that intermediate level rates apply to long-term capital gains from certain transactions, such as sales or exchanges of collectibles, section 1202 stock (with respect to a portion of the gain), and section 1250 property with gain attributable to straight-line depreciation. Section 1(h)(11) provides authority to the Secretary to issue such regulations as are appropriate to apply these rules in the case of sales or exchanges by pass-thru entities and of interests in pass-thru entities. This document provides rules for sales or exchanges of interests in partnerships, S corporations, and trusts. This document also provides rules relating to dividing the holding period of a partnership interest.

Explanation of Provisions

In general, prior to the 1997 Act, individuals were taxed on capital gains at the same rate as ordinary income, except that the rate for net capital gain was capped at 28 percent. The 1997 Act provided for lower maximum rates of taxation on gain from the sale or exchange of certain types of property. As amended by the 1998 Act, section 1(h) currently provides for maximum capital gains rates on the sale or exchange of certain types of property in three categories: 20-percent rate gain, 25-percent rate gain, and 28-percent rate gain. Twenty percent rate gain is net capital gain from the sale or exchange of capital assets held for more than one year, reduced by the sum of 25-percent rate gain and 28-percent rate gain. Twenty-five percent rate gain is limited to unrecaptured section 1250 gain. Unrecaptured section 1250 gain is the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent, reduced by any net loss in the 28-percent rate gain category. Twenty-eight percent rate gain is capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to section 408(m)(3)) held for more than one year, a portion of the gain attributable to the sale of section 1202 stock, and capital gains and losses determined under the rules of section 1(h)(13), reduced by net short-term capital loss for the taxable year and any long-term capital loss carryover under section 1212(b)(1)(B).

Collectibles Gain and Unrecaptured Section 1250 Gain

The sale or exchange of an interest in a partnership with a long-term holding period generally will result in capital gain in the 20-percent rate gain category to the extent that section 751(a) is not applicable. Section 751(a) generally provides that an amount received in exchange for a partnership interest, to the extent attributable to unrealized receivables and inventory, shall be considered as an amount realized from the sale or exchange of property other than a capital asset. Section 1250 property is treated as an unrealized receivable for purposes of section 751 to the extent of the amount that would be treated as gain to which section 1250(a) would apply.

The sale or exchange of stock in an S corporation with a long-term holding period generally will result in gain or loss in the 20-percent rate gain category, unless an exception to capital gain treatment applies. Certain of those exceptions are provided in sections 304, 306, 341, and 1254.

The sale or exchange of an interest in a trust with a long-term holding period generally will result in gain or loss in the 20-percent rate gain category. However, if the transferor is treated as the owner of the portion of the trust attributable to an interest under sections 673 through 679, the transferor is treated as transferring an undivided interest in the assets of the trust rather than an interest in the trust itself.

Effective for taxable years ending after May 6, 1997, when an interest in a partnership, an S corporation, or a trust held for more than one year (or more than 18 months during certain periods in 1997) is sold or exchanged, section 1(h) provides special treatment for "collectibles gain" in property held by a partnership, S corporation, or trust and for "section 1250 capital gain" in property held by a partnership. Specifically, section 1(h)(6)(B) provides that any gain from the sale of an interest in a partnership, S corporation, or trust which is attributable to unrealized appreciation in the value of collectibles shall be treated as gain from the sale or exchange of a collectible, applying rules similar to section 751(a) to determine the amount of the gain. In addition, under section 1(h)(7)(A) (in conjunction with sections 751(a) and (c)), the amount of long-term capital gain (not otherwise treated as ordinary income under section 751(a)) that would be treated as ordinary income under section 751(a) if section 1250 applied to all depreciation (section 1250 capital gain) must be taken into account in computing unrecaptured section 1250 gain when an interest in a partnership (with a holding period of more than one year, or more than 18 months during certain periods in 1997) is sold or exchanged. See H. Rep. No. 105–356, 105th Cong. 1st Sess. (1997), at 16, fn. 11; S. Rep. No. 105–174, 105th Cong. 2d Sess. (1998), at 149, fn. 65.

The proposed regulations provide guidance with respect to the application of these rules to a sale or exchange of an interest in a partnership, S corporation, or trust holding assets with collectibles gain and a partnership holding assets with section 1250 capital gain. Generally, the amount of such gain is determined by reference to the gain that would be allocated to the selling partner, shareholder, or beneficiary (to the extent attributable to the portion of the transferred interest that is subject to long-term capital gain) if the partnership, S corporation, or trust had sold all of its collectibles or if the partnership had sold all of its section 1250 property in a fully taxable transaction immediately before the transfer of the partnership, S corporation, or trust interest. Special rules are provided where the partner, S corporation shareholder, or trust beneficiary recognizes less than all of the gain upon the sale or exchange of its interest.

In addition, for purposes of applying section 1(h)(7)(B), which provides that a taxpayer's unrecaptured section 1250 gain cannot exceed the taxpayer's net section 1231 gain, gain from the sale of a partnership interest that results in section 1250 capital gain is not treated as section 1231 gain even if section 1231 could apply to the disposition of the underlying partnership property. Although section 1(h)(7) (in combination with section 751) applies a limited look-thru rule for purposes of determining the capital gain rate applicable to the sale of a partnership interest, no similar look-thru rule applies for purposes of applying section 1231. Anomalous results would follow if section 1250 capital gain derived from the sale of a partnership interest were treated as section 1231 gain for purposes of applying the limitation in section 1(h)(7)(B) but not for purposes of actually applying section 1231.

Determination of Holding Period in a Partnership

In view of the long-established principle that a partner has a single basis in a partnership interest (see Rev. Rul. 84–53 (1984–1 C.B. 159)), there is some confusion under current law as to how the principles of section 1223 apply to the sale of an interest, or a portion of an interest, in a partnership. The proposed regulations provide rules relating to the allocation of a divided holding period with respect to an interest in a partnership. These rules generally provide that the holding period of a partnership interest will be divided if a partner acquires portions of an interest at different times or if an interest is acquired in a single transaction that gives rise to different holding periods under section 1223. The holding period of a portion of a partnership interest shall be determined based on a fraction that is equal to the fair market value of the portion of the partnership interest to which the holding period relates (determined immediately after the acquisition) over the fair market value of the entire partnership interest. A selling partner may use the actual holding period of the portion of a partnership interest sold if the partnership is a "publicly traded partnership" (as defined under section 7704(b)), the partnership interest is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion of the interest transferred. Otherwise, the holding period(s) of the transferred interest must be divided in the same ratio as the holding period(s) of the partner's entire partnership interest.

These proposed regulations do not contain a specific anti- abuse rule regarding holding periods. However, there may be situations where taxpayers will attempt to undertake abusive transactions using the rules in these regulations. For instance, taxpayers may attempt to shift gain from property with a short-term holding period to property with a long-term holding period by contributing the short-term property to a partnership and selling the partnership interest. Because the basis of a partnership interest cannot be segregated to a portion of an interest, basis in the portion of a partnership interest with a long-term holding period could reduce gain attributable to the portion of a partnership interest with a short-term holding period in situations where such interest was recently received in exchange for contributed short-term capital gain property. In appropriate situations, the IRS may attack such abusive transactions under a variety of judicial doctrines, including substance over form or step transaction, or under §1.701–2 of the regulations.

Proposed Effective Date

The amendments are proposed to be effective for all transfers of interests in a partnership, S corporation, or trust and for all distributions from a partnership on or after the date the regulations are published as final regulations in the **Federal Register.**

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the facts that: (1) the time required to prepare and file the statement is minimal (currently estimated at 10 minutes per statement); and (2) it is anticipated that, as a result of these regulations, small entities will file no more than one statement per year. Furthermore, taxpayers will have to respond to the requests for information contained in §1.1(h)–1(e) only if there is a sale or exchange of an interest in a partnership, an S corporation, or a trust that holds certain property. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. Chapter 6) is not required.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 18, 1999, beginning at 1 p.m. in **room 3411** of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must request to speak and submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 28, 1999. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Jeanne Sullivan, Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

Part 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1(h)–1 is added to read as follows:

§1.1(h)–1 Capital gains look-through rule for sales or exchanges of interests in a partnership, S corporation, or trust.

(a) *In general.* When an interest in a partnership held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., section 751(a)), collectibles gain, section 1250 capital gain, and residual long-term capital gain or loss. When stock in an S corporation held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., sections 304, 306, 341, 1254), collectibles gain, and residual long-term capital gain or loss. When an interest in a trust held for more than one year is sold or exchanged, a transferor who is not treated as the owner of the portion of the trust attributable to the interest sold or exchanged (sections 673 through 679) (a non-grantor transferor) may recognize collectibles gain and residual long-term capital gain or loss.

(b) *Look-through capital gain*—(1) *In general.* Look-through capital gain is the share of collectibles gain allocable to an interest in a partnership, S corporation, or trust, plus the share of section 1250 capital gain allocable to an interest in a partnership, determined under paragraphs (b)(2) and (3) of this section.

(2) *Collectibles gain and collectibles loss*—(i) *Definitions.* For purposes of this section, collectibles gain and collectibles loss mean gain or loss, respectively, from the sale or exchange of a collectible (as defined in section 408(m) without regard to section 408(m)(3)) that is a capital asset held for more than 1 year, but only to the extent such gain is taken into account in computing gross income, and such loss is taken into account in computing taxable income.

(ii) *Share of collectibles gain allocable to an interest in a partnership, S corporation, or trust.* When an interest in a partnership, S corporation, or trust held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, the transferor shall recognize as collectibles gain the amount of net collectibles gain (but not net collectibles loss) that would be allocated to that partner (taking into account any remedial allocation under §1.704-3(d)), shareholder, or beneficiary (to the extent attributable to the portion of the partnership interest, S corporation stock, or trust interest transferred that was held for more than one year) if the partnership, S corporation, or trust transferred all of its collectibles in a fully taxable transaction immediately before the transfer of the interest in the partnership, S corporation, or trust. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, S corporation, or trust, the same methodology shall apply to determine the collectibles gain recognized by the transferor, except that the partnership, S corporation, or trust shall be treated as transferring only a proportionate amount of each of its collectibles determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. With respect to the transfer of an interest in a trust, this paragraph applies only to transfers by non-grantor transferors (as defined in paragraph (a) of this section).

(3) *Section 1250 capital gain*—(i) *Definition.* For purposes of this section, *section 1250 capital gain* means the long-term capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent.

(ii) *Share of section 1250 capital gain allocable to interest in partnership.* When an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, there shall be taken into account under section 1(h)(7)(A)(i) in determining the partner's unrecaptured section 1250 gain the amount of section 1250 capital gain that would be allocated (taking into account any remedial allocation under §1.704–3(d)) to that partner (to the extent attributable to the portion of the partnership interest transferred that was held for more than one year) if the partnership transferred all of its section 1250 property in a fully taxable transaction immediately before the transfer of the interest in the partnership. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, the same methodology shall apply to determine the section 1250 gain recognized by the transferor, except that the partnership shall be treated as transferring only a proportionate amount of each section 1250 property determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange.

(iii) *Limitation with respect to net section 1231 gain.* In determining a transferor partner's net section 1231 gain (as defined in section 1231(c)(3)) for purposes of section 1(h)(7)(B), the transferor partner's allocable share of section 1250 capital gain in partnership property shall not be treated as section 1231 gain, regardless of whether the partnership property is used in the trade or business (as defined in section 1231(b)).

(c) *Residual long-term capital gain or loss.* The amount of residual long-term capital gain or loss recognized by a partner, shareholder of an S corporation, or beneficiary of a trust on account of the sale or exchange of an interest in a partnership, S corporation, or trust shall equal the amount of long-term capital gain or loss that the partner would recognize under section 741, that the shareholder would recognize upon the sale or exchange of stock of an S corporation, or that the beneficiary would recognize upon the sale or exchange of an interest in a trust (pre-look-through long-term capital gain or loss) minus the amount of long-term capital gain determined under paragraph (b) of this section (look-through capital gain).

(d) *Special rule for tiered entities.* In determining whether a partnership, S corporation, or trust has collectibles gain and whether a partnership has section 1250 capital gain, such partnership, S corporation, or trust shall be treated as owning its proportionate share of the property of any partnership, S corporation, or trust in which it owns an interest, either directly or indirectly through a chain comprised exclusively of such entities.

(e) *Notification requirements.* Rules similar to those that apply to the partners and the partnership under section 751(a) shall apply in the case of sales or exchanges of interests in a partnership, S corporation, or trust that holds property with collectibles gain and in the case of sales or exchanges of interests in a partnership that holds property with section 1250 capital gain. See §1.751–1(a)(3).

(f) *Examples.* The following examples illustrate the requirements of this section:

Example 1. Collectibles gain. (i) *A* and *B* are equal partners in a personal service partnership (*PRS*). *B* transfers *B*'s interest in *PRS* to *T* for $15,000 when *PRS*'s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

ASSETS

	Adjusted Basis	Market Value
Cash	$ 3,000	$ 3,000
Loans Owed to Partnership	10,000	10,000
Collectibles	1,000	3,000
Other Capital Assets.	6,000	2,000
Capital Assets	7,000	5,000
Unrealized Receivables	0	14,000
Total.	$20,000	$32,000

LIABILITIES AND CAPITAL

Liabilities	$ 2,000	$ 2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	$20,000	$32,000

(ii) At the time of the transfer, *B* has held the interest in *PRS* for more than one year, and none of the property owned by *PRS* is section 704(c) property. The total amount realized by *B* is $16,000, consisting of the cash received, $15,000, plus $1,000, *B*'s share of the partnership liabilities assumed by T. See section 752. *B*'s basis for the partnership interest is $10,000 ($9,000 plus $1,000, *B*'s share of partnership liabilities). *B*'s undivided one-half interest in *PRS* includes a one-half interest in the partnership's unrealized receivables and a one-half interest in the partnership's collectibles.

(iii) If *PRS* were to sell all of its section 751 property in a fully taxable transaction immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated $7,000 of ordinary income from the sale of *PRS*'s unrealized receivables. Therefore, *B* will recognize $7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 ($6,000) and the amount of ordinary income or loss determined under §1.751–1(a)(2) ($7,000) is the partner's capital gain or loss on the sale of the partnership interest under section 741. In this case, the transferor has a $1,000 pre-look-through long-term capital loss.

(iv) If *PRS* were to sell all of its collectibles in a fully taxable transaction immediately prior to the transfer of *B*'s partnership interest to T, *B* would be allocated $1,000 of collectibles gain from the sale of the collectibles. Therefore, *B* will recognize $1,000 of collectibles gain on account of the collectibles held by *PRS*.

(v) The difference between the transferor's pre-look-through long-term capital gain or loss (–$1,000) and the look-through capital gain determined under this section ($1,000) is the transferor's residual long-term capital gain or loss on the sale of the partnership interest. Under these facts, *B* will recognize a $2,000 residual long-term capital loss on account of the sale or exchange of the interest in *PRS*.

Example 2. Special allocations. Assume the same facts as in *Example 1*, except that under the partnership agreement, all gain from the sale of the collectibles is specially allocated to *B*, and *B* transfers *B*'s interest to *T* for $16,000. All items of income, gain, loss, or deduction of *PRS*, other than the collectibles gain, are divided equally between A and *B*. Under these facts, *B*'s pre-look-through long-term capital gain would be $0. If *PRS* were to sell all of its collectibles in a fully taxable transaction immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated $2,000 of collectibles gain from the sale of the collectibles. Therefore, *B* will recognize $2,000 of collectibles gain on account of the collectibles held by *PRS*. *B* also will recognize $7,000 of ordinary income (determined under §1.751–1(a)(2)) and a $2,000 long-term capital loss on account of the sale of *B*'s interest in *PRS*.

Example 3. Net collectibles loss ignored. Assume the same facts as in *Example 1*, except that the collectibles held by *PRS* have an adjusted basis of $3,000 and a fair market value of $1,000, and the other capital assets have an adjusted basis of $4,000 and a fair market value of $4,000. If *PRS* were to sell all of its collectibles in a fully taxable transaction immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated $1,000 of collectibles loss. Because none of the gain from the sale of the interest in *PRS* is attributable to unrealized appreciation in the value of collectibles held by *PRS*, the net loss in collectibles held by *PRS* is not recognized at the time *B* transfers the interest in *PRS*. *B* will recognize $7,000 of ordinary income (determined under §1.751–1(a)(2)) and a $1,000 long-term capital loss on account of the sale of *B*'s interest in *PRS*.

Example 4. Collectibles gain in an S corporation. (i) A corporation (*X*) has always been an S corporation and is owned by individuals A, *B*, and *C*. In 1996, *X* invested in antiques. Subsequent to their purchase, the antiques appreciated in value by $300. A owns one-third of the shares of *X* stock and has held that stock for more than one year. A's adjusted basis in the *X* stock is $100. If A were to sell all of the *X* stock to *T* for $150, A would realize $50 of pre-look-through long-term capital gain.

(ii) If *X* were to sell its antiques in a fully taxable transaction immediately before the transfer to *T*, A would be allocated $100 of collectibles gain on account of the sale. Therefore, A will recognize $100 of collectibles gain (look- through capital gain) on account of the collectibles held by *X*.

(iii) The difference between the transferor's pre-look-through long-term capital gain or loss ($50) and the look-through capital gain determined under this section ($100) is the transferor's residual long-term capital gain or loss on the sale of the S corporation stock. Under these facts, A will recognize $100 of collectibles gain and a $50 residual long-term capital loss on account of the sale of A's interest in *X*.

(g) *Effective date.* This section applies to transfers of interests in partnerships, S corporations, and trusts that occur on or after the date these regulations are published as final regulations in the **Federal Register.**

Par. 3. Section 1.1223–3 is added to read as follows:

§1.1223–3 Rules relating to the holding periods of partnership interests.

(a) *In general.* A partner shall have a divided holding period in an interest in a partnership if:

(1) The partner acquired portions of an interest at different times; or

(2) The partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods determined under section 1223.

(b) *Accounting for holding periods of an interest in a partnership.* The portion of a partnership interest to which a holding period relates shall be determined by reference to a fraction that is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates over the fair market value of the entire partnership interest (determined immediately after the transaction).

(c) *Sale or exchange of all or a portion of an interest in a partnership*—(1) *Sale or exchange of entire interest in a partnership.* If a partner sells or exchanges the partner's entire interest in a partnership, any capital gain or loss recognized shall be divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the interest in the partnership is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less.

(2) *Sale or exchange of a portion of an interest in a partnership.* (i) If the ownership interest in a publicly traded partnership (as defined under section 7704(b)) is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion of the partnership interest transferred, the selling partner may use the actual holding period of the portion transferred.

(ii) If a partner has a divided holding period in a partnership interest, and paragraph (c)(2)(i) of this section does not apply, then the holding period of the transferred interest shall be divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the transferor partner would realize if the entire interest in the partnership were transferred in a fully taxable transaction immediately before the actual transfer.

(d) *Distributions*—(1) *In general.* A partner's holding period in a partnership interest is not affected by distributions from the partnership.

(2) *Character of capital gain or loss recognized as a result of a distribution from a partnership.* If a partner is required to recognize capital gain or loss as a result of a distribution from a partnership, then the capital gain or loss recognized shall be divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the distributee partner would realize if such partner's entire interest in the partnership were transferred in a fully taxable transaction immediately before the distribution.

(e) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. Division of holding period—contribution of money and a capital asset. (i) A contributes $5,000 of cash and a nondepreciable capital asset *A* has held for two years to a partnership (*PRS*) for a 50% interest in *PRS*. *A*'s basis in the capital asset is $5,000, and the fair market value of the asset is $10,000. After the exchange, *A*'s basis in *A*'s interest in *PRS* is $10,000, and the fair market value of the interest is $15,000. *A* received one-third of the interest in *PRS* for a cash payment of $5,000 ($5,000/$15,000). Therefore, *A*'s holding period in one- third of the interest received (attributable to the contribution of money to the partnership) begins on the day after the contribution. *A* received two-thirds of the interest in *PRS* in exchange for the capital asset ($10,000/$15,000). Accordingly, pursuant to section 1223(1), *A* has a two-year holding period in two-thirds of the interest received in *PRS*.

(ii) Six months later, when *A*'s basis in *PRS* is $12,000 (due to a $2,000 allocation of partnership income to *A*), *A* sells the interest in *PRS* for $15,000. Assuming *PRS* holds no inventory or unrealized receivables (as defined under section 751(c)) and no collectibles or section 1250 property, *A* will realize $3,000 of capital gain. *A*s determined above, one-third of *A*'s interest in *PRS* has a holding period of one year or less, and two-thirds of *A*'s interest in *PRS* has a holding period equal to two years and six months. Therefore, one-third of the capital gain will be short-term capital gain, and two-thirds of the capital gain will be long-term capital gain.

Example 2. Division of holding period—contribution of money, section 1231 property, and other property. In exchange for a 30% interest in a partnership (ABC), *A* contributes to *ABC* $50,000 cash and equipment used in a trade or business and held for more than one year with a fair market value of $100,000 and an adjusted basis of $40,000. The equipment has a recomputed basis under section 1245 of $60,000. Accordingly, a portion of the equipment equal in value to $20,000 is section 1245 property that is not section 1231 property. See §1.1245–6(a). *A*'s partnership interest has a fair market value of $150,000, a basis of $90,000, and a divided holding period. *A* received 46.67% ($70,000/$150,000) of the interest in *ABC* in exchange for property that is neither a capital asset nor section 1231 property (that is, cash of $50,000 and a portion of the equipment attributable to section 1245 recapture in an amount equal to $20,000). Therefore, *A*'s holding period for 46.67% of *A*'s interest begins on the day after the exchange of the property for the partnership interest. *A* received 53.33% ($80,000/$150,000) of *A*'s interest in *ABC* in exchange for section 1231 property. Accordingly, *A*'s holding period for 53.33% of *A*'s interest includes *A*'s holding period for the section 1231 property.

Example 3. Division of holding period when capital account is increased by contribution. *A, B, C,* and *D* are equal partners in a partnership (*PRS*), and the fair market value of a 25% interest in *PRS* is $90x. *A, B, C,* and *D* each contribute an additional $10x to partnership capital, thereby increasing the fair market value of each partner's interest to $100x. As a result of the contribution, each partner has a new holding period in the portion of the partner's interest in *PRS* that is attributable to the contribution. That portion equals 10% ($10x/$100x) of each partner's interest in *PRS*.

Example 4. Sale or exchange of a portion of an interest in a partnership. (i) *A* contributes $5,000 in cash and a capital asset with a fair market value of $5,000 and a basis of $2,000 to a partnership (*PRS*) in exchange for an interest in *PRS*. At the time of the contribution, *A* had held the contributed property for two years. Six months later, when *A*'s basis in *PRS* is $7,000, *A* transfers one-half of *A*'s interest in *PRS* to T for $6,000 at a time when *PRS*'s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

ASSETS

	Adjusted Basis	Market Value
Cash	$5,000	$5,000
Unrealized Receivables	0	6,000
Capital Asset 1	3,000	8,000
Capital Asset 2	2,000	5,000
Capital Assets	5,000	13,000
Total	$10,000	$24,000

(ii) Although at the time of the transfer *A* has not held *A*'s interest in *PRS* for more than one year, 50% of the fair market value of *A*'s interest in *PRS* was received in exchange for property with a long-term holding period. Therefore, 50% of *A*'s interest in *PRS* has a long-term holding period.

(iii) If *PRS* were to sell all of its section 751 property in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated $3,000 of ordinary income. One-half of that amount ($1,500) is attributable to the portion of *A*'s interest in *PRS* transferred to *T*. Accordingly, *A* will recognize $1,500 ordinary income and $1,000 ($2,500 – $1,500) of capital gain on account of the transfer to T of one-half of *A*'s interest in *PRS*. Fifty percent ($500) of that gain is long-term capital gain and 50% ($500) is short-term capital gain.

Example 5. Sale or exchange of a portion of an interest in a partnership. (i) The facts are the same as in *Example 4*, except that capital asset 1 is a collectible that was purchased by *PRS* more than one year earlier. If capital asset 1 were sold or exchanged in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated

$2,500 of collectibles gain. Fifty percent of that amount ($1,250) is attributable to the portion of *A*'s interest in *PRS* sold to *T*. The collectibles gain allocable to the portion of the transferred interest in *PRS* with a long-term holding period is $625 (50% of $1,250). Accordingly, *A* will recognize $625 of collectibles gain on account of the transfer of one-half of the interest in *PRS*.

(ii) The difference between the amount of pre-look-through long-term capital gain or loss ($500) and the look-through capital gain ($625) is the amount of residual long-term capital gain or loss that *A* will recognize on account of the transfer of one-half of the interest in *PRS*. Under these facts, *A* will recognize a residual long-term capital loss of $125 and a short-term capital gain of $500.

Example 6. Sale of units of interests in partnership. *A* publicly traded partnership (*PRS*) has ownership interests that are segregated into identifiable units of interest. *A* owns 10 limited partnership units in *PRS* for which *A* paid $10,000 three years ago. Later, *A* purchases five additional units for $10,000 at a time when the fair market value of each unit has increased to $2,000. *A*'s holding period for one-third ($10,000/$30,000) of the interest in *PRS* begins on the day after the purchase of the five additional units. Less than one year later, *A* sells five units of ownership in *PRS* for $11,000. At the time, *A*'s basis in the 15 units of *PRS* is $20,000, and *A*'s capital gain on the sale of 5 units is $4,333 (amount realized of $11,000 – one-third of the adjusted basis or $6,667). For purposes of determining the holding period, *A* can designate the specific units of *PRS* sold. If *A* properly identifies the five units sold as five of the ten units for which *A* has a long-term holding period, the capital gain realized will be long-term capital gain.

Example 7. Disproportionate distribution. In 1997, *A* and *B* each contribute cash of $50,000 to form and become equal partners in a partnership (*PRS*). Sometime later, *A* receives a distribution worth $22,000 from *PRS*, which reduces *A*'s interest in *PRS* to 36%. After the distribution, *B* owns 64% of *PRS*. The holding periods of *A* and *B* in their interests in *PRS* are not affected by the distribution.

Example 8. Gain or loss as a result of a distribution. In 1996, *A* contributes property with a basis of $10 and a fair market value of $10,000 in exchange for an interest in a partnership (*ABC*). In 1999, when *A*'s interest in *ABC* is worth $12,000, *A* contributes $6,000 cash in exchange for an additional interest in *ABC*, bringing the fair market value of *A*'s interest to $18,000. The holding period of *A*'s interest in *ABC* is determined immediately after that exchange. *A*'s holding period in one-third of *A*'s interest in *ABC* ($6,000 cash contributed over the $18,000 value of the entire interest) begins on the day after the cash contribution. (*ABC* holds no inventory or unrealized receivables.) Later in 1999, *ABC* makes a cash distribution to *A* of $10,000. *A*'s basis in *ABC* immediately before the distribution is $6,010. Accordingly, *A* must recognize $3990 of capital gain as a result of the distribution. See section 731(a)(1). One-third of the capital gain recognized as a result of the distribution is short-term capital gain, and two-thirds of the capital gain is long-term capital gain. After the distribution, *A*'s basis in the interest in *PRS* is $0, and the holding period for the interest in *PRS* continues to be divided in the same proportions as before the distribution.

(f) *Effective date.* This section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after the date final regulations are published in the **Federal Register.**

Par. 4. Section 1.741–1 is amended by adding paragraphs (e) and (f) to read as follows:

§1.741–1 Recognition and character of gain or loss on sale or exchange.

* * * * *

(e) For rules relating to the capital gain or loss recognized when a partner sells or exchanges an interest in a partnership that holds appreciated collectibles or section 1250 property with section 1250 capital gain, see §1.1(h)–1.

(f) For rules relating to dividing the holding period of an interest in a partnership, see §1.1223–3.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 6, 1999, 8:45 a.m., and published in the issue of the Federal Register for August 9, 1999, 64 F.R. 43117)

Foundations Status of Certain Organizations

Announcement 99–80

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

Childrens Rights Council–Lincoln Chapter, Lincoln, NE
Chimes District of Columbia Inc., Baltimore, MD
Chimes Virginia Inc., Baltimore, MD
Chinatown Beautification Committee, Boston, MA
Chinese Evangelical Fellowship Inc., Zion, IL
Christian Employment Network, Bellevue, WA
Chuck Pack Memorial Scholarship Foundation Inc., Louisa, KY
Circle Building Power for Peaceful Social Change, Kannapolis, NC
Circleville Artist Series, Circleville, OH
Cities in Schools-Aurora 2000 Inc., Aurora, IL
Citizens Creating Responsive Communities Inc., Elizabethtown, KY
Citizens for Equal Protection Inc., Omaha, NE
City of Church Hill Community Chest Inc., Church Hill, TN
Civil Society Development Program Inc., Nashville, TN
Claremont Homes Tenant Council Inc., Baltimore, MD
Clarendon School District Three Educational Foundation, Turbeville, SC
Clean Cities Recycling Inc., Griffith, IN
Clean Start Services Inc., Yonkers, NY
Coalition for Adolescent Pregnancy Prevention Soldotna, AK
Coalition for the Advancement of Science Education in Mass, Worcester, MA
Collegiate School of New Hampshire, Nashua, NH
Collier Family Planning Inc., Naples, FL
Colorado Institute for Youth Leadership, Colorado Springs, CO
Columbia Jewish Congregation Development Corporation, Columbia, MD
Commonwealth Community Services Incorporated, Elsa, TX
Communities in Schools of Pueblo Colorado, Pueblo, CO
Community AIDS Advocate Project, Stuart, FL
Community Interaction Service Inc., Bossier City, LA
Community Justice for Children Inc., Glendale, AZ
Community Services Network Inc., Orlando, FL
Community Share Foundation Inc., Carrboro, NC
Company of Fools Inc., Richmond, VA
Concerned Americans for Responsible Driving Inc., St. Louis, MO
Concerts for the Heartland Inc., New York, NY
Congaree Soccer Association Inc., Cayce, SC
Connecticut Positive Action Coalition Inc., Hartford, CT
Consortium for Sustainable Village-Based Development, Denver, CO
Cool Schools Corporation of New York City, New York, NY
Cooperative Baptist Fellowship Foundation Inc., Atlanta, GA
Cornerstone Foundation Inc., Tucson, AZ
Coryton & Company Inc., Gates Mills, OH
Council for Electronic Revenue Communication Advancement, Chicago, IL
Coupons Inc., Boston, MA
Creative Options Inc., Ellicott City, MD
Creative Training Centers Inc., Springfield, IL

Credo Housing Inc., Oakland, CA
Crestwood Services Inc., Langhorne, PA
Crispus Attucks Neighborhood Development Organization Inc., Lancaster, PA
Crossroads Foundation Inc., Webb City, MO
Cross Training Ministries, St. Paul, MN
Cuban-American Endowment for the Arts Inc., Coral Gables, FL
Cumberland County Parent Awareness Inc., Portland, ME
Daily Care Nurses Inc., Providence, RI
DCL Foundation Inc., Del City, OK
De Azur Inc., New York, NY
December Rose Association, Long Beach, CA
Defense Equal Opportunity Management Institute Fndtn Inc., Patrick AFB, FL
Del Rio Rotary Housing, Del Rio, TX
Delbac Inc., Brooklyn, NY
Demopolis City Schools Foundation Inc., Demopolis, AL
Desert Services for Children & Families with AIDS, Cathedral City, CA
Design and Construction Quality Institute, Silver Spring, MD
Destinasian, Chicago, IL
Destined for Unity Inc., Palmetto, FL
Development Consortium for Innovative Classrooms, Issaquah, WA
DHS Athletic Boosters Inc., Dunnellon, FL
Diabetes Directory, Colorado Springs, CO
Diamond and Jewelry Industries Development Corporation, New York, NY
Disabled Divers International Inc., Santa Barbara, CA
Discipleship for Christ, Littleton, CO
Ditson Street Senior Housing Inc., Dorchester, MA
Divide County Quarterback Club Inc., Fortuna, ND
Divine Assistance Inc., Rocky Point, NY
Division for Early Childhood Inc., Pine Bluff, AR
Dog Star Institute Inc., Missoula, MT
Dominguez Family Shelter, Carson, CA
Donan & Associates Community Services, Denver, CO
Dreams into Action Inc., New York, NY
Drug Abuse and Violence Prevention Outreach Inc., Montgomery, AL
Dunbar Coalition Inc., Tucson, AZ
East Harlem Neighborhood Based Alliance Corporation, New York, NY
East Lake Youth Association, Birmingham, AL
Education Law Foundation Inc., Northampton, MA
Educational & Healthcare Development Foundation of Beloit, Colorado Springs, CO
Educational Initiative, Asheville, NC
Educational Institute of America Inc., Greensboro, NC
Educational Seminars Inc., Haverhill, MA
El Caldito, Las Cruces, NM
El Dorado Fire and Rescue Association, Santa Fe, NM
Elbert County Council for Effective Literacy Inc., Elberton, GA
Emergency Living Family Fund Inc., Columbia, SC
Emory Valley Center Foundation, Oak Ridge, TN
En Garde Inc., Overland Park, KS
Enid Tennis Booster Club, Enid, OK
Entrepreneurial Resource Center, San Diego, CA
Entz Elementary Parent Teacher Organization, Mesa, AZ
Epilepsy Services of Southeast Florida Inc., West Palm Beach, FL
Erie County Coalition of Mental Health Consumers, Erie, PA
Etowah Junior Pro Basketball Booster Club, Etowah, TN
Families & Children Together Inc., Amherst, VA
Family and Child Enrichment Services Inc., Marietta, OH
Family Network of Jacksonville Inc., Jackson, IL
Family Resource Services Inc., Atlanta, GA
Family Support Group Inc., Phoenix, AZ
Featherstone, Ames, IA
Feed the Hungry Inc., Brooklyn, NY
Firehouse Arts Resources, Columbus, OH
First Night Freeport Inc., Freeport, NY
Florence United Methodist Properties Inc., Florence, KY
Foundation for Educational Excellent Kildeer School District, Buffalo Grove, IL
Foundation for Human Rights and Democracy in South Africa, Washington, DC
Foundation for the Milwaukee Fire Education Center Inc., Milwaukee, WI
Foundation for the Support and Enhancement of High Ed in Bolivia, Roland, AR
Foundation-Governor Baxter School for the Deaf, Portland, ME
Foundation of Cabo Verde Inc., East Providence, RI
Fountain of Love Ministries, Monroe, LA
Framingham Housing Development Corporation II, Framingham, MA
Franchell Boswell Educational Foundation Inc., Chicago, IL
Franciscan Counselling Services Inc., Boston, MA
Frankfort Franklin County Education Foundation Inc., Frankfort, KY
Franklin Resident Council Inc., Franklin, VA
Freedom for Youth Inc., Helena, AR
Friends of AE-4 PTSA, Seattle, WA
Friends of Argus and Aurora House, Arlington, VA
Friends of Davenport Tennis, Davenport, IA
Friends of Fire District Fourteen Inc., Maynard, MA
Friends of Landmark Academy Inc., Wilton, CT
Friends of Maricopa Medical Center, Phoenix, AZ
Friends of S C P A, San Diego, CA
Friends of the Catholic University of America Rowing Association, Arlington, VA
Friends of the Gordon Highlands, Washington, DC
Friends of the Northwest, Clackamas, OR
Friends of the Northwest Regional Library, Philadelphia, PA
Friends of the Performing Arts Inc., Baltimore, MD
Friends of the Webster Animals Inc., Webster, MA
Friends of Valley Debate Inc., Des Moines, IA
Frontiers International Inc-Chicago, Chicago, IL
Gainesville Commission on the Status of Women Inc., Gainesville, FL
Ganoderma International Research Institute, New York, NY
Georgia Association of Community Leaders, Warner Robins, GA
Georgia Council on Compulsive Gambling Incorporated, Atlanta, GA
Georgia Mountain Theatre Inc., Atlanta, GA

GHS Band Alumni Association Inc., Gardner, MA
Globewide Network Academy, Austin, TX
Goffstown Area Diversion Program Inc., Goffstown, NH
Golden Gate Middle School PTO Inc., Naples, FL
Good News Incorporated, Oklahoma City, OK
Government Research Institute of Western New York Inc., Buffalo, NY
Grand Avenue Substance Abuse Prevention-Education Center, Dequincy, LA
Grand View Industries Inc., Grand Junction, CO
Grant Hussey Foundation, Eden Prairie, MN
Grantme Entertainment Inc., Miami, FL
Gratitude Retreat Inc., Greenville, SC
Great Artists Series, St. Louis, MO
Great Expectations I Inc., Nelson, MN
Greater Houston Renewal and Development, Houston, TX
Greek Spirit of Boston Association a Non-profit Corporation, Jamacia Plain, MA
Grosse Pointe Public Schools Foundation, Grosse Pointe, MI
Growing Need Inc., Batavia, IL
H O S T Youth Shelter Inc., Lagrange, KY
Hacemos Scholarship Foundation, Dallas, TX
Haiti Resource Cosortium International Inc., New York, NY
Hampton Roads Public Transportation Alliance, Hampton, VA
Hand in Hand Early Childhood Center Inc., Lowville, NY
Happy Child Mission, Carrollton, TX
Harlem Empowerment Zone Arts Industry Council Inc., New York, NY
Harlem Institute, New York, NY
Harrison Educational Foundation Incorporated, Harrison, NY
HBHCI HUD 1 Inc., New Port Richey, FL
HBHCI HUD 2 Inc., New Port Richey, FL
HBHCI HUD 3 Inc., New Port Richey, FL
Healthy Intercollegiate Visions Coalition, Raleigh, NC
Heart Sparks, Louisville, KY
Heartland Telecommunications Consortium Inc., Huron, SD
Henry S Baird Parent-Teacher Organization, Green Bay, WI
Heritage South Commercial Revitalization Association, Toledo, OH
Hi-Tech Council of Sarasota & Manatee Counties Inc., Sarasota, FL
Hicksville High School Band Parents Association Inc., Hicksville, NY
Hidden Theater, Minneapolis, MN
Higher Plains Ministry Inc., Atlanta, GA
Highland Rim Residential Services, Tullahoma, TN
Historic Savage Mill Inc., Savage, MD
Holistic Managed Care Services Inc., Chicago, IL
Homeless Empowerment Project Inc., Cambridge, MA
Homeless Veterans Action Corporation, Tuscaloosa, AL
Hoosh Doh DII to Development Inc., Pinon, AZ
Hope Thru Horses, New Bury Park, CA
Horizon International Childrens Services Inc., Buckner, KY
Housing Program Administrator Inc., Washington, DC
Hughes Neighborhood Housing Inc., Wheaton, MD
Hunnewell School Parent-Teacher Organization Inc., Wellesley, MA
Illinois Partners for Social & Economic Development, Chicago, IL
Illinois Philippine Medical Society, Oakbrook, IL
Immaculate Conception Church-St. Paul Mission Chapel Restoration, Douglassville, PA
Indian World Inc., Detroit, MI
Information Networking and Communication Association, Bronx, NY
Inmate Family Services Inc., Philadelphia, PA
Innovation Cities Development Corporation, Jackson, NJ
Innovative Horizons Inc., Bartlesville, OK
Inside the Nonprofits Charitable Trust, New York, NY
Institute for Child and Adolescent Sexual Health Inc., Minneapolis, MN
Institute for Community Development, Richmond, VA
Institute for Mediation Training, La Grange Park, IL
Institute for Peaceable Community Inc., Cambridge, MA
Institute for Systemic Change in Education, Ann Anbor, MI
Inter-Act, Cicero, IL
Interactive Visual Technologies Center of North Carolina Inc., Raleigh, NC
Intercessions Child Welfare Agency, Chicago, IL
International Center for Clubhouse Development Inc., New York, NY
International Center for Management Decisions Inc., Ithaca, NY
International Childrens Centers Inc., Chicago, IL
International Commission for Joint Projects in Modern Russian History, New York, NY
International Tzedakah Foundation Inc., Milwaukee, WI
Iowa Prairie Network Inc., Mason City, IA
Irish Dance Teachers Association of North America Inc., Irvington, NJ
Jasper Pride Inc., Jasper, TX
Jewel County Arts Council Inc., Mankato, KS
Jewish Association on Aging, Pittsburgh,, PA
Joanco Development Inc., Anoka, MN
Jordan High School Athletic Booster Inc., Durham, NC
JTD Homes Inc., Orangeburg, SC
Julius Humann Elementary School Parent Teacher Organization, Lincoln, NE
Kansas Leadership Forum Inc., Manhattan, KS
Kansas University Ophthalmic Foundation, Kansas City, KS
Keeper of the Plains Scholarship Board Inc., Enid, OK
Kenai Peninsula Opportunities Incorporated, Kenai, AK
Kendall Khoury League Inc., Miami, FL
Kids Island Inc., Poquoson, Va
Kids Kastle Inc., Chicago, IL
Kids Voting Horry County Inc., Myrtle Beach, SC
Kid works Inc., Easton, MD
Kidz Xpress, Orangeburg, SC
Kindergarten Association of Connecticut Inc., Branford, CT
King of Kings Community Center, Fresno, CA
Kip Laxson Ministeries Inc., Columbia, MO
Knob Noster Panther Athletic Booster Club, Knob Noster, MO
Korean-American Gospel Foundation, Greenville, SC
L Alliance Francaise de Panama City Inc., Panama City, FL

La Pradera Park Council Inc., Phoenix, AZ
Lake County Youth Orchestra, Grayslake, IL
Lamokin Village Resident Council Inc., Chester, PA
Latinos for a Better Brooklyn Inc., Brooklyn, NY
Leadership Albany Inc., Albany, GA
Leadership Monterey Peninsula Inc., Monterey, CA
Leonard Eisner Memorial Committee Inc., New York, NY
Liberty House Inc., Manchester, NH
Life International Inc., Clarksville, IN
Life Line International, Seattle, WA
Lifequest International, Seattle, WA
Lincoln Larimer Lemington Belmar Citizens Revitalization Development, Pittsburgh, PA

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Weighted Average Interest Rate Update

Notice 99–39

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for July 1999 is 5.98 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
August	1999	6.01	5.41 to 6.31	5.41 to 6.61

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans Division. For further information regarding this notice, call (202) 622-6076 between 2:30 and 3:30 p.m. Eastern time (not a toll-free number). Mr. Newman's number is (202) 622-8458 (also not a toll-free number.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedral Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 1999–1 through 1999–26 will be found in Internal Revenue Bulletin 1999–27, dated July 6, 1999.

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